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The East Asian Miracle



Also in this issue:

**Rural Credit
Indigenous People
Housing Policy**

FINANCE & DEVELOPMENT

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The East Asian Miracle Building a Basis for Growth

JOHN PAGE

MUCH OF East Asia's dramatic growth is due to superior accumulation of physical and human capital. But these economies were also better able than most to allocate these resources to highly productive investments. They did this with combinations of policies, always including market-oriented "fundamentals," but sometimes relying on tailored government interventions.

Outsiders have pondered the success of East Asia—what some call a "miracle"—with wonder and admiration. Never before have countries expanded so fast for so long. From 1965 to 1990, the region's 23 economies grew faster than those of all other regions (see Chart 1), and income inequality declined, sometimes dramatically. Most of this achievement can be attributed to the stellar growth performance of eight economies: Japan; the "four tigers"—Hong Kong, the Republic of Korea, Singapore, and Taiwan Province of China; and the three newly industrializing economies (NIEs) of Southeast Asia—Indonesia, Malaysia, and Thailand.

Moreover, these eight economies share other characteristics that set them apart from other developing economies. These include:

- more rapid output and productivity growth in agriculture;
- higher rates of growth of manufactured exports, with their share of world exports of manufactures leaping from 9 percent in 1965 to 21 percent in 1990;
- earlier and steeper declines in fertility;
- higher growth rates of physical capital, exceeding 20 percent of GDP on average between 1960 and 1990, supported by higher rates of domestic savings (see Chart 2);
- higher initial levels and growth rates of human capital; and
- generally higher rates of productivity growth.

As other developing countries debate whether they can emulate East Asia's success, key questions arise. What were the sources of East Asia's success? What was the role of public policy in fostering growth? Can policies that were successful in East Asia be replicated by other economies?

In an effort to answer these questions, the World Bank undertook a major comparative study of economic growth and public policy in East Asia, *The East Asian Miracle* (see box). One of the key findings is that East Asia succeeded because it got the economic policy fundamentals right. Macroeconomic performance was unusually stable, providing the necessary framework for private investment. Policies to increase the integrity of the banking system and make it more accessible to nontraditional savers increased the levels of financial savings. Education policies that focused on primary and secondary education

generated rapid increases in labor force skills. Agricultural policies stressed productivity change and did not tax the rural economy excessively. All of these economies kept price distortions within reasonable bounds and were open to foreign ideas and technology. To this extent, there was no economic "miracle;" East Asia's success simply reflects sound economics.

But these economic fundamentals do not tell the entire story. Almost all of the East Asian economies engaged, at one time or another, in some form of policy interventions—one of the most controversial aspects of development policy. Selective interventions took many forms, including mild repression of interest rates, directed credit, selective industrial promotion, and trade policies that pushed manufactured exports.

What was the relative role of economic fundamentals and intervention in East Asia's success? The study maintains that East Asian economies thrived because governments used a combination of fundamental and interventionist policies to (1) accumulate physical and human capital; (2) allocate this capital to highly productive investments; and (3) acquire and master technology and achieve rapid productivity growth.

Accumulating capital

The East Asian economies accumulated both physical and human capital much more rapidly and consistently than other economies, accounting for a large portion of their superior performance.

Building human capital

East Asia began its rapid growth with an educational advantage over other developing economies and sustained that advantage through explicit policies of investing in basic education. Primary and secondary education levels were higher in these economies in the 1960s than in other low- and middle-income economies. Public spending concentrated on primary and secondary education. For example, in the mid-1980s, Indonesia, Korea, and Thailand devoted more than 80 percent of their education budget to basic education. Declining fertility and rapid economic growth meant that, even when education investment as a share of GDP remained constant, more resources were available per child in East Asia than in other developing regions.

The limited public funding for

postsecondary education was used primarily for science and technological education (including engineering), while university education in the humanities and social sciences was handled through the private system. Some of these economies also imported educational services on a large scale, particularly for disciplines requiring specialized skills.

Creating effective and secure financial systems. Financial sector policies in these economies were designed to encourage savings and channel the funds into activities with high social returns.

Increasing savings. The East Asian economies increased savings by ensuring generally positive real interest rates on deposits and creating secure bank-based financial systems through strong prudential regulation, good supervision, and institutional reforms. In addition, Japan and Taiwan established postal savings systems to attract small savers. These systems offered small savers greater security and lower transaction costs than the private sector and made substantial resources available to government.

Some governments also used a variety of more interventionist mechanisms to increase savings. Malaysia and Singapore guaranteed high minimum private savings rates through mandatory provident fund contributions. Japan, Korea, and Taiwan all imposed stringent controls and high interest rates on loans for consumer items as well as stiff taxes on so-called luxury consumption.

Increasing investment. The East Asian economies encouraged investment by several means. First, they did a better job than most developing economies of creating infrastructure complementary to private investment. Second, they created an investment-friendly environment through a combination of tax policies and measures that kept the relative prices of capital goods low, largely by maintaining low tariffs on imported capital goods. These fundamental policies had an important impact on private investment. Third, and more controversial, most of these economies kept deposit and lending rates below market-clearing levels, a practice known as financial repression.

Japan, Korea, Malaysia, Taiwan, and Thailand experienced extended periods of mild financial repression. In these economies, real deposit rates were zero or mildly positive and stable, but because savings were not very responsive to changes in real interest rates (above zero), governments could mildly repress interest rates on deposits with a minimal impact on savings and pass the lower rates to final borrowers, thus subsidizing corporations. This policy of mild financial repression differed significantly from the repressed financial regimes of other low- and middle-income countries because interest rates were both more stable and positive in real terms.

Allocating capital

But high levels of physical and human capital are not a guarantee for success. Resources, once accumulated, need to be allocated to high-yielding activities. Again, these economies used a combination of market mechanisms and government intervention to guide allocative decisions in both the labor and capital markets. Labor market policies tended to use the market and reinforce its flexibility. In the capital market, governments intervened systematically

Chart 1
East Asia's stellar performance
(average GNP per capita growth rate, in percent, 1965-90)

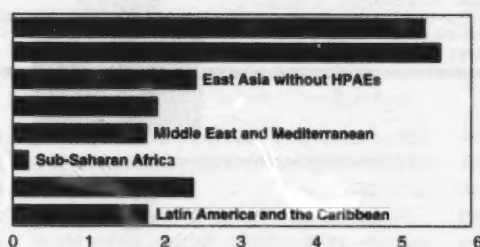
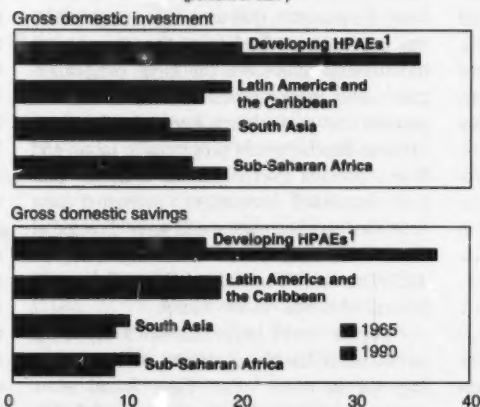


Chart 2
Exceptional savings and investment rates
(percent of GDP)



Source: World Bank.

Note: The regional averages are unweighted.

¹ High performing Asian economies (HPAEs): Indonesia, Hong Kong, Japan, Malaysia, the Republic of Korea, Singapore, Taiwan Province of China, and Thailand.

both to control interest rates and to direct credit but did so within a framework of generally low subsidies to borrowers, targeting of allocations to areas of presumed market failure, and careful monitoring.

Letting markets work: flexible labor markets. Government roles in labor markets in the successful Asian economies contrast sharply with the situation in most other developing countries. The governments in these economies have generally been less vulnerable and less responsive than other developing country governments to organized labor demands to legislate a minimum wage. Rather, they have focused their efforts on generating jobs, effectively boosting the demand for workers. As a result, employment levels have risen first, followed by market- and productivity-driven increases in wage levels. Because wages, or at least wage-rate increases, have been downwardly flexible in response to changes in the demand for labor, adjustment to macroeconomic shocks has generally been quicker and less painful in East Asia than in other developing regions.

Assisting the market: capital markets. Capital markets serve to allocate funds to competing investments. Each of the Asian economies made some attempts to direct credit to priority activities; all except Hong Kong gave automatic access to credit for exporters. Housing was a priority in Hong Kong and Singapore, while agriculture and small and medium-size enterprises were targeted sectors in Indonesia, Malaysia, and Thailand. Taiwan has recently targeted technological development. Japan and Korea have at various times used credit as a tool of industrial policy to promote the shipbuilding, chemical, and automobile industries.

The implicit subsidy of directed credit programs in the East Asian economies was generally small, especially in comparison with other developing economies, but access to credit and the signal of government support to favored sectors or enterprises were important. In Korea, the subsidy from preferential credit was large during the 1970s, reflected in a large gap between bank and curb market interest rates. This gap has declined sharply in recent years, as Korea has shifted away from heavy credit subsidies to selected sectors. In Japan implicit subsidies were small, and the direc-

tion of credit may have been more important as a signaling and insurance mechanism than as an incentive.

Although East Asia's directed credit programs were designed to achieve policy objectives, they nevertheless included strict performance criteria. In Japan, public bank managers employed rigorous economic and financial evaluations to select among applicants from sectors that were being targeted by the government. In Korea, the government individually monitored the large conglomerates using market-oriented criteria, such as exports and profitability. Recent assessments of some directed credit programs in Japan and Korea provide microeconomic evidence that they increased investment, promoted new activities and borrowers, and were directed at firms with high potential for technological spillovers (see "The Role of Credit Policies in Japan and Korea" in this issue).

Directed credit programs without strong performance-based allocation and monitoring—as in some other East Asian economies—have been largely unsuccessful. The changing level of financial sector development and the increasing openness of these economies to international capital flows have

caused directed credit programs to decline in importance.

Promoting productivity

The East Asian economies used several strategies for increasing productivity growth, including absorbing foreign technology, employing selective industrial policies, and encouraging rapid export growth.

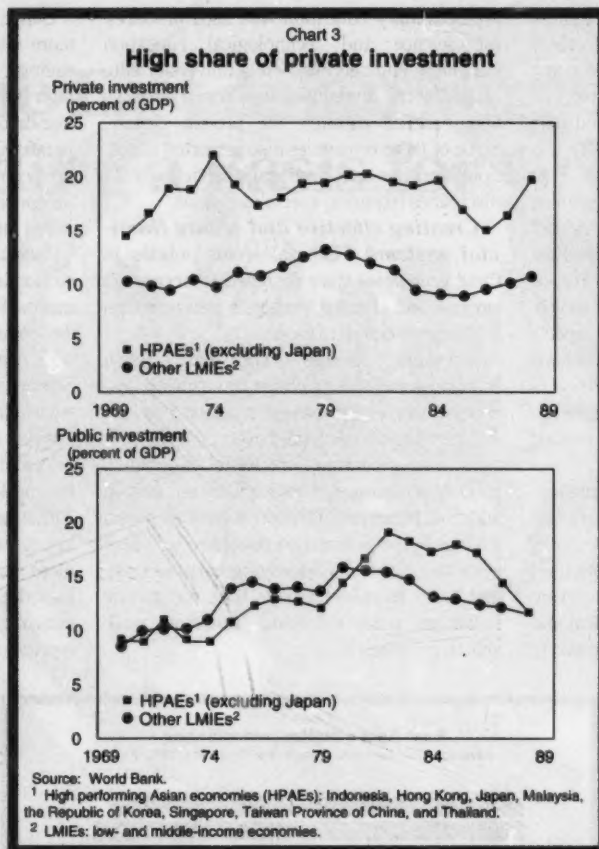
Absorbing foreign technology. These economies actively sought foreign technology through a variety of mechanisms. All welcomed technology transfers in the form of licenses, capital goods imports, and foreign training. Openness to foreign direct investment speeded technology acquisition in Hong Kong, Malaysia, Singapore, and, more recently, Indonesia and Thailand. Japan, Korea, and, to a lesser extent, Taiwan restricted foreign direct investment but offset this disadvantage by aggressively acquiring foreign knowledge through licenses, overseas education, and capital goods imports.

Promoting specific industries. Most East Asian governments have pursued sector-specific industrial policies

to some degree. The best known instances include Japan's policies to promote heavy industry in the 1950s and the subsequent imitation of these policies in Korea. These policies included import protection as well as subsidies for capital and other imported inputs. Malaysia, Singapore, Taiwan, and even Hong Kong have also established programs—typically with more moderate incentives—to accelerate the development of advanced industries. Despite these actions, there is little evidence that industrial policies have affected either the sectoral structure of industry or rates of productivity change (see "Roots of East Asia's Success" in this issue).

Encouraging export strategies. The active promotion of manufactured exports was a significant source of these economies' rapid productivity change. Although all of them except Hong Kong passed through an import-substitution phase, with high and variable protection of domestic import substitutes, these periods ended earlier than in other economies. Hong Kong, Malaysia, and Singapore adopted trade regimes that were close to free trade.

Japan, Korea, and Taiwan halted import liberalization, often for extended periods, and



heavily promoted exports. Thus, while incentives were largely equal, they were the result of countervailing subsidies rather than of trade neutrality; promotion of exports coexisted with some protection of the domestic market. In the Southeast Asian economies, in contrast, governments gradually but continuously liberalized the trade regime, supplemented by institutional support for exporters, to achieve the export push. Exchange rate policies in all economies were liberalized and currencies frequently devalued to support export growth. Because governments were credibly committed to the export push strategy, producers, even those in the protected domestic market, knew that sooner or later their time to export would come.

Manufactured export growth provided a powerful mechanism for technological upgrading. Because world markets for technology are imperfect, firms that export have greater access to technology than those that produce import substitutes or nontraded goods. Exports can confer benefits to the enterprise and spillovers to the rest of the economy that are not reflected in market prices. These information-related spillover effects are an important source of rapid total factor productivity growth. Both cross-economy evidence and more detailed studies of total factor productivity performance of industries in Japan, Korea, and Taiwan confirm the significance of exports for rapid productivity growth.

Other innovative features

The success of the East Asian economies stems partly from the policies they adopted and partly from the institutional mechanisms they created to implement them. The context within which growth-oriented policies were undertaken differs from that of most other low- and middle-income countries in two important respects. First, political leadership adopted the principle of shared economic growth as a major social goal, and, second, governments relied on the private sector.

The principle of shared growth. To win the support of the society at large, East Asian leaders supported the principle of shared growth, promising, in effect, that as the economy expanded, all groups would benefit. But sharing growth raised complex coordination problems. First, leaders had to convince economic elites to support pro-growth policies. Then they had to persuade the elites to share the benefits of growth with the middle class and the poor. Finally, to win the cooperation of the middle class and the poor, leaders had to show them that they would indeed benefit from future growth.

Very explicit mechanisms were used to

demonstrate that all would have a share of future wealth. Korea and Taiwan carried out comprehensive land reform programs; Indonesia used rice and fertilizer price policies to raise rural incomes; Malaysia introduced explicit wealth-sharing programs to improve the lot of ethnic Malays vis-à-vis the better-off ethnic Chinese; Hong Kong and Singapore undertook massive public housing programs. In several economies, governments assisted workers' cooperatives and established programs to encourage small and medium-size enterprises. Whatever the form, these programs demonstrated that the government intended for all to share in the benefits of growth.

Role of the private sector. Private, not public, investment was the major engine of rapid growth in these economies. Between 1970 and 1990, virtually all of the difference in



John Page
a US citizen, is Chief Economist of the Middle East and North Africa Region of the World Bank. A graduate of Stanford and Oxford Universities, he was the research team leader and principal author of *The East Asian Miracle*.

investment between these economies and other low- and middle-income economies was due to their much higher levels of private investment (see Chart 3).

Responsible macroeconomic management, particularly low inflation and small fiscal deficits, encouraged long-term planning and investment and may have been responsible as well for exceptional savings rates. East Asian leaders built a business-friendly environment, of which a major element was a legal and regulatory structure that was generally hospitable to private investment. But beyond this, these economies have, with varying degrees of success, focused on enhancing communications between business and government. Japan, Korea, Malaysia, and Singapore have established forums, called deliberation councils, to enable private sector groups to influence the formulation and implementation of government policies relevant to their interests. In contrast to lobbying, where rules are murky and groups seek secret advantage over one another, the deliberation councils made the

allocation rules clear to all participants.

Some of these economies have gone a step further, creating "contests" that combined competition with the benefits of cooperation among firms and between government and the private sector. Such contests range from very simple nonmarket allocation rules, such as access to rationed credit for exporters, to very complex coordination of private investment in the government-business deliberation councils of Japan and Korea. The key feature of each contest, however, is that the government distributes rewards—access to credit or foreign exchange—based on performance, which the government and competing firms monitor.

What can East Asia teach?

To what extent does East Asia offer lessons for other developing economies? The diversity of experience, the variety of institutions, and the great variation in policies mean that there is no one model for success. Rather, each of the eight economies studied used a combination of policies at different times to perform the functions needed for rapid growth: rapid accumulation, efficient allocation, and higher productivity growth.

While the fundamental, market-oriented economic policies can be recommended without reservation, the efficacy of more institutionally demanding strategies has not been established in other settings and is clearly difficult to imitate when the fundamentals are not securely in place. The problem is not only to try to understand which specific policies may have contributed to growth but also to understand the institutional and economic circumstances that made them viable.

The research results indicate that promoting specific individual industries was generally not successful and therefore holds little promise for other developing economies. Mild financial repression, combined with directed credit, has worked in some circumstances. Strategies to promote exports and to adapt and improve the technology available in industrial countries have been by far the most generally successful selective approaches used by these economies and hold the greatest promise for other developing economies. ■

For a comprehensive discussion, see The East Asian Miracle: Economic Growth and Public Policy, a World Bank Policy Research Report published by the Oxford University Press, New York, NY, USA, 1993. This report was prepared by a team led by John Page and comprising Nancy Birdsall, Ed Campos, W. Max Corden, Chang-Shik Kim, Lawrence MacDonald, Howard Pack, Richard Sabot, Joseph Stiglitz, and Marilou Uy.

Roots of East Asia's Success

DANNY M. LEIPZIGER AND VINOD THOMAS

THE RECIPE for East Asia's "miracle" certainly varied from country to country, but a set of country studies demonstrates that a core of sound economic policies laid the necessary foundation for all. The studies also dispel some myths about the role of industrial policy and underscore the importance of nonideological and reversible policymaking.

If asked in the early 1950s to predict the successful industrializers in the ensuing three decades, only a seer would have chosen the East Asian "tigers"—Hong Kong, the Republic of Korea, Singapore, or Taiwan Province of China. All were bereft of natural resources and were having difficulty providing the basic necessities for their populations. Today, no other group of developing countries has performed as well in sustaining rapid growth, reducing poverty, or raising standards of living. The success stories of the first generation Asian "tigers" have led to a second generation of rapidly industrializing Asian "cubs"—Indonesia, Malaysia, and Thailand.

Although often spoken of as a single group, the East Asian economies are, in fact, remarkably diverse. The region includes some of the richest and the poorest of the world's developing countries, some of the most populous and some of the least, some with a store of natural resources and some with virtually none. Further, these economies have pursued a

diverse mix of policies with varying degrees of government intervention. Countries' policies have also changed over time.

Why have the different experiences in East Asia produced uniformly good results? To answer this question, a set of cross-country studies was undertaken by teams from the World Bank and in-country nationals to examine the experiences of the East Asian economies and the public policies underpinning them (see box containing list of studies). These studies complemented the project on *The East Asian Miracle*.

The country studies reinforce the view that sound macroeconomic policies, investment in people, and outward orientation—along with political stability—are central to success. As for government intervention, here the record is mixed. Success in the first generation of newly industrializing economies (NIEs) involved more government intervention—such as selective industrial policies—than in the second generation (see Box 1). The East Asian experience, therefore, does not make a clear case for a *laissez-faire* approach to economic policymaking or for a heavy hand on the tiller. What the studies do show, however, is that the way governments supported markets and fashioned an institutional framework for effective policy implementation was critical. Here the message is not more government, but better government.

Macroeconomic policies

Perhaps the factor most consistently present in the East Asian economies was a sound and disciplined macroeconomic policy framework, characterized by fiscal discipline, strong investment performance—especially in the area of human capital—and aggressive export development. These policies were the hallmark of the first generation of NIEs and would also largely characterize the second generation of NIEs in their successful periods.

Fiscal discipline. Over the past quarter

century, the fiscal and current account deficits in developing East Asia have been less than half the average for other developing countries. For most of its recent history, East Asia has managed to keep inflation in single digits. Equally important, when macroeconomic control lapsed, it was swiftly re-established. For example, when Korea's inflation rate hovered near 20 percent in the late 1970s as a result of the expensive drive to develop the Heavy and Chemical Industry (HCI), the government acted decisively to cut fiscal spending. Indonesia's public sector deficit exceeded 4 percent of GDP in 1986 as oil prices declined, but the government made sharp budget cuts and reduced the deficit to a manageable 1.3 percent by 1989. Similarly, in Malaysia, a persistent fiscal deficit, although financed in a relatively noninflationary way, reached unhealthy proportions in the early 1980s and required large reductions. In some countries, prudent fiscal behavior was aided by legislation that limited the size of public deficits (e.g., Indonesia, Taiwan, and Thailand), while in others the anti-inflation biases of the political leadership (e.g., Korea, Malaysia, and Singapore) served to keep macroeconomic control high on the policy agenda.

Investments: more and better.

Investment as a share of GDP has risen sharply in East Asia over the past quarter of a century, and estimates of rates of return are similarly favorable. In Korea, for example, on World Bank projects alone, the rates of return are much higher than worldwide averages. The quality of investments derives in part from superior growth performance that validates past investment decisions—a kind of virtuous circle—but also stems from above-average implementation and the strength of institutions.

Many of the gains in East Asia come from total factor productivity growth, which averaged three to six times the developing country average. Recent evidence attempts to link this



unexplained portion of productivity growth with the quality of the labor force, specifically its education and training. This was clearly an East Asian strength. Educational attainment in the region exceeded that in other areas as early as 1960, but educational investments thereafter also rose, leading to universal primary education, widely available and higher-quality secondary education, and programs to attract returning university graduates from overseas, especially in technical areas. High-quality labor, as seen in Korea and Singapore, for example, has aided industrial flexibility, increased economic efficiency, and promoted greater equity.

Export push. East Asia's outward orientation and its success in penetrating international markets are well documented. The region has made remarkable progress in expanding trade, particularly in manufactured exports, and in attracting foreign direct investment. Outward orientation should not be equated with openness, however. During the 1960s and 1970s, several economies exhibited moderate import protection. The effective protection rate for manufacturing was nearly 30 percent in Korea, 50 percent in Thailand, and 70 percent in Indonesia. Although significant import protection existed well into the 1980s, offsetting policies managed to ensure that import protection did not produce the anti-export bias that was so prevalent elsewhere. This distinction can be traced to the region's general unwillingness to allow the exchange rate to become overvalued and to the fact that exporters were given access to offsetting incentives (for instance, duty exemption, free access to foreign exchange, and free trade zones) that favored exports. There was also effective institutional support for exports (especially in Korea, Singapore, and Taiwan) and considerable labor market flexibility.

Foreign direct investment was welcomed in these economies, inspiring the transfer of financing and know-how in the later NIEs. In

1991, Malaysia, Thailand, and Indonesia were the third, fifth, and seventh largest recipients respectively of foreign direct investment among developing countries. In Malaysia, for instance, many multinationals in electronics invested in the country in response to active government encouragement and today Malaysia is the developing world's largest exporter of semiconductors. Singapore's public policy was fashioned in large measure to attract multinationals, as foreign direct investment was the backbone of its development strategy.

Diverse industrial policies

No doubt, the most controversial aspect of policy in East Asia has been industrial policy. For better or for worse, it has captured the imagination of development observers, seen by some as the major reason for East Asia's success and by others as an obstacle to growth (see "Government Intervention and Growth: Is the East Asian Experience Relevant for New Zealand?" in this issue). Views concerning not only what the policy should be on "picking winners," for example, but also what industrial policy was and what

Box 1 Diversity in industrial policy: Singapore and Hong Kong

The Government of Singapore had few qualms about intervening to supplement market forces and bring about desired industrial change. Clearly, the size and malleability of the economy made control easier, but Singapore also developed institutions that made it possible. Without capital, technology, or entrepreneurs, Singapore put its industrialization squarely on the shoulders of multinational corporations and foreign direct investment. When necessary, it used government-linked companies to push its development agenda.

Recognizing that their city-state, with its limited physical resources, would have to depend on re-exports, Singapore's first generation of leaders built their industrial strategy around labor policy. Wages were a policy tool to ensure competitiveness. Balancing these labor market interventions were social policies (such as housing) to improve living standards and a major public role in education and training.

In effect, the government tried to position its labor force to be attractive to multinationals, adjusting its prices, augmenting its skills, and tinkering with financial incentives to change its trade pattern and stay ahead of its competitors in East Asia.

Hong Kong had always been different from the early generation of NIEs, particularly in the small and noninterventionist role of its government. For most of the past 40 years, Hong Kong's economic growth and productivity were the highest in the region. Small enterprises flourished, fostered by vibrant local entrepreneurs and by a government dedicated to macroeconomic stability and free market policies. The government saw its role in terms of providing infrastructure, a strong regulatory environment, and public housing and education. Underpinned by a strong civil service and administrative structure, export entrepreneurship flourished. In recent years, as local wages have risen, a new and dynamic link with the coastal provinces of China has once again provided Hong Kong with a new source of growth.

it accomplished in certain countries cover a wide spectrum. Industrial policy has many meanings but refers primarily to a set of policies that change a country's industrial structure. The cases of selective industrial policy intervention involve, among the first generation NIEs, Korea during 1973-79, Singapore, and Taiwan to a lesser extent; among the later NIEs, they center around episodic experiences in Indonesia and Malaysia.

The case studies reveal some interesting insights. While the full answer on the efficacy of intervention in Korea and Taiwan will never be known, it is clear that most interventions had international competitiveness as the ultimate aim for the targeted industries. Benefits in the form of directed credits and subsidies were offered in exchange for performance in achieving export targets and international competitiveness. Thus, intervention in Korean automobiles differed from subsidies together with protection in Brazilian computers, insofar as success was measured by export performance and preferences were tied to performance. Both Korea and Taiwan eventually opted for liberalization and stepped back from activist industrial policies. Singapore viewed industrial policy as the interface between national policy and multinational investment in Singapore, while Hong Kong adopted a stance of positive nonintervention (see Box 2). All succeeded, however.

The cases of Indonesia and Malaysia show that strong industrial intervention failed in both cases and was followed by liberalization episodes. Malaysia faced mounting deficits and inefficiency in its state-dominated heavy industries and thus began a policy of disengagement and eventual privatization. The conclusion of many, although not all, observers of Malaysia's drive to boost the Heavy Industries Corporation of Malaysia (HICOM) is that it resembled import substitution more than export promotion, that it was part and parcel of a larger pro-Malay redistribution plan, and that it lacked the checks and balances of successful industrialization drives elsewhere in East Asia. More to the point, Malaysia was able to propel itself onto a higher growth path by virtue of its attractiveness to foreign direct investors. Similarly, Indonesia, which was impoverished in the 1960s, has emerged as another dynamo. It did so by abandoning selective industrial promotion and following outward-oriented policies. Thailand, for its part, did not have the institutions to attempt an activist industrial policy, and its foray into heavy, publicly led industrialization (the so-called Eastern Seaboard Project) was effectively scaled back.

Hence, active and selective interventionist industrial policies are neither necessary nor

Box 2 Variation within the East Asian group: early versus later NIEs

While economic and political stability, an export drive, investment in human capital, and an efficient bureaucracy were common features of successful East Asian economies, the first generation of NIEs, with the exception of Hong Kong, had some systematic differences from the second generation of NIEs.

In the first generation of NIEs the state generally had a more forceful role in industrialization. Starting with visionary leadership and supported by strong economic ministries, governments "went for broke," acquired technology feverishly, and invested heavily in upgrading labor skills. A few used directed credit as part of their strategy, relying on state enterprises when private firms were lacking. What lowered the risks of these policies were strong macroeconomic discipline and the use of international price signals as guides to performance. Macroeconomic discipline meant that countries abandoned imprudent policies when stability was threatened. The use of international prices helped them to measure the performance of infant industries.

The second generation of NIEs differed considerably from the first in terms of initial conditions and, to some extent, political institutions. The availability of resources in Indonesia, Malaysia, and Thailand allowed a more relaxed pace of development. More reliant on foreign investment than on aid, these economies did not have to follow such an aggressive policy of acquiring technology. Where selective industrial policies were attempted, these policies largely failed. Yet regional contagion (the transfer of technology and ideas from other successful countries in the region), low wages, and strong economic fundamentals fostered export industries. Liberalization and reforms removed the public sector from inefficient activities in Malaysia and Indonesia. Open capital accounts contrasted with the financial controls used in Japan and Korea in earlier decades. A common feature, however, was access to expanding world markets, particularly the US market.

sufficient for successful industrialization. Countries entertaining the notion of intervening to alter their industrial structure dramatically would need to weigh both the costs and potential gains of such an initiative. Even in environments where the government has the best intentions and the strongest institutions, as in Korea, the cost has been significant in terms of macroeconomic disruption and distortions in the financial sector. Others have done well without such directed policies, especially in recent years, when the flows of international investment have been large and technology has crossed borders with ease.

The common feature is that success was based on export development. Governments did not merely provide protection for a local industry (as was the case in many countries outside the region) but supported many kinds of industries to help them achieve export competitiveness. Crucial elements were that governments guided, but did not override, the decisions of firms; international price signals were used to gauge efficiency and success; and firms were offered support in exchange for specific performance requirements.

While success was not universal in East Asia, it cannot be a coincidence that most successful industrializers were concentrated in one region. This fact not only leads to argu-

ments of "regional contagion," namely, the proximity to other successful economies that encouraged the imitation of outward-oriented policies as well as the transfer of capital and technology, but also to the search for causes of success in East Asian institutions.

Pragmatic policymaking

Although sound economic policies laid the foundation for success, the style of policymaking seems to be as important as the policies themselves. The governments in the successful countries maintained objectivity about these policies and reversed them when they failed. Korea's sharp policy reversal with respect to its heavy industry drive is a case in point. Faced with the effects of the second oil shock and the domestic overheating of the economy produced by the HCI drive, Korea introduced drastic stabilization measures, reversing credit allocation policies after supporting the heavy industry sector for almost a decade. Trade liberalization replaced protection, commercial banks were privatized, and the attempts to pick winners abandoned.

Similar examples can be taken from the policy history of Indonesia and Malaysia, which dabbled in import-substitution policies in the 1980s and subsequently sharply reversed their policies. In Malaysia, the government shifted

from promoting HICOM industries relying on public sector investments to a reform program centered on privatization. Indonesia also shifted course and began to open up its economy.

Policies in successful industrializers were constantly subject to review and scrutiny. When policies appeared ineffective, or when sectoral policies conflicted with macroeconomic equilibrium, they were abandoned. Policymakers in these countries were aware that they were accountable for performance and that the standards of performance were known.

Effective policymaking was aided by an effective bureaucracy. In most East Asian countries, because government service confers status, governments are able to select the most qualified individuals. Starting with a highly motivated and well-trained cadre of officials, East Asian governments by and large were able to organize themselves efficiently, often using the concept of core economic ministries (e.g., in Indonesia, Korea, Singapore, and Taiwan). A pioneer among organizations was the Economic Planning Board in Korea, which combined the planning, economic management, and budget functions and was led by a deputy prime minister, a virtual economic czar.

Bureaucracies tend to work well when their objectives are clear and they enjoy strong political support, as was the case in Korea, Singapore, and Taiwan among the first generation of NIEs and in Indonesia and Malaysia in the second generation. Hong Kong is somewhat of a special case in this respect, although the administrative structure of government with respect to financial stability and clear rules of the game points to strong controls in certain areas. Nor does Thailand fit this model precisely, as it lacked cohesive leadership at times and did not centralize authority; nevertheless, the case study on Thailand clearly points out that certain government entities, in particular the Bank of Thailand, provided stability and, in fact, served as a counterweight to fragmented political forces.

Successful bureaucracies internalized national objectives and were seen to be acting in the national interest. Unlike bureaucracies in many other parts of the world—although even in East Asia, some countries, for example, the Philippines, were not able to achieve a national consensus on the direction of development policy and the role of government—bureaucrats acted with the strong support of national leaders and were seen not as impediments to change but rather as agents of economic change.

The East Asian countries have a record of maintaining political and economic stability and of pursuing long-term economic goals.

The alliance between strong leaders and strong bureaucracies is a common feature in most of them. Most of these East Asian economies were by and large able to develop a national consensus concerning the direction of economic policy, beginning with land redistribution in Korea and Taiwan and large-scale public housing investments in Hong Kong and Singapore. Leadership somehow produced a political and economic consensus, seen formally in Singapore, for example, where a tripartite apparatus was established combining government, business, and labor. In Malaysia, it took the form of a pro-Malay development strategy that became the central driving force. In Korea, a symbiotic relationship between business and government was formed, a link that had some real costs but one that also helped produce the successful Korean *chaebol*, or conglomerates, of today.

In addition, observers have attributed some of the economic success to the concentration of political power in East Asian economies. Clearly, some regimes were authoritarian; but equating political control and economic success is too simplistic and misleading. Authoritarianism has not been in short supply in many parts of the world, yet the majority of those regimes have been failures. The East Asian experience shows success with various forms of political structure. The common feature, however, is that these regimes had an economic vision, and more important, that they themselves expected to be judged on their economic performance.

In sum . . .

The diversity of experience within East Asia suggests that universal and sweeping prescriptions are not possible and that country-specific circumstances will prevail. Yet,

evidence points to the dominant contribution of stable and competitive economic policies to the unleashing of private entrepreneurship. More often than not, the key to the policymaking process was the positive role of government in charting a development course, creating a longer-term vision shared among key participants, and fashioning an institutional framework for effective policy implementation. When searching for replicability, other countries would do well to take a closer look at these common policy and institutional aspects of East Asia's development success. ■



Danny M. Leipziger
a US citizen, is a Lead Economist in the World Bank's Latin America and the Caribbean Region. He was Country Studies Director of The East Asia Miracle project. He holds a PhD from Brown University.



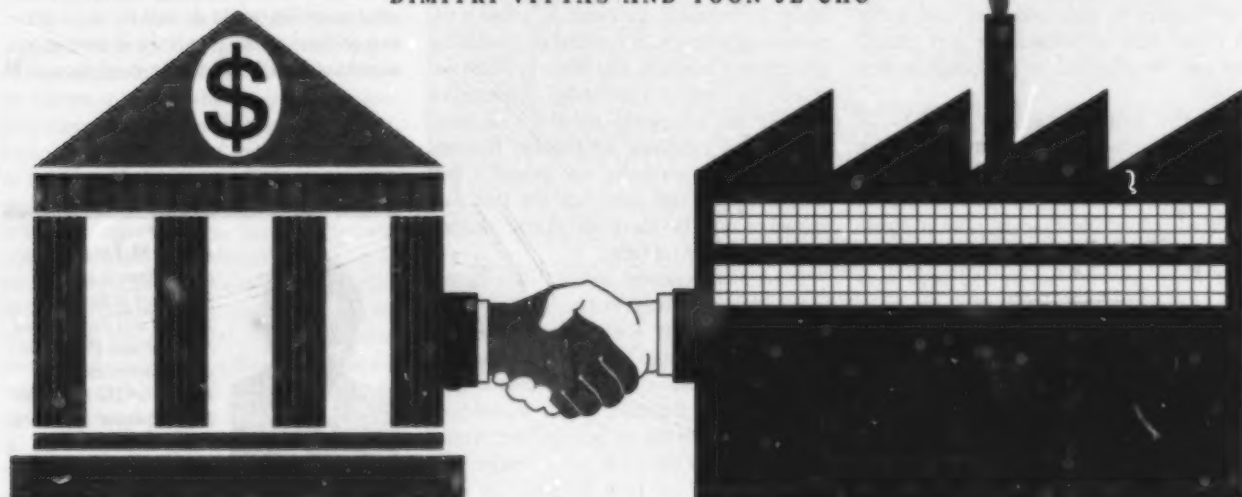
Vinod Thomas
from India, is Chief Economist in the World Bank's East Asia and Pacific Region. He holds a PhD from the University of Chicago and has taught at Vassar College (USA) and the University of São Paulo.

The country studies project, which includes case studies of individual economies, as well as several cross-country papers, was directed by Danny M. Leipziger. Individual studies have been disseminated by the World Bank in the *Lessons of East Asia* series. These include:

- An Overview of Country Experience** by Danny M. Leipziger and Vinod Thomas
- Hong Kong: A Unique Case of Development** by Leung Chuen Chau
- Indonesia: Development Transformation and Public Policy** by Amar Bhattacharya and Mari Pangestu
- Korea: A Case of Government-Led Development** by Kihwan Kim and Danny M. Leipziger
- Malaysia: Growth, Equity, and Structural Transformation** by Ismail Muhd Salleh and Saba Dhevan Meyanathan
- Singapore: Public Policy and Economic Development** by Teck-Wong Soon and C. Suan Tan
- Thailand: The Institutional and Political Underpinnings of Growth** by Scott Christensen, David Dollar, Ammar Siamwalla, and Pakorn Vichayanond
- Government Policy and Productivity Growth: Is East Asia an Exception?** by Vinod Thomas and Yan Wang
- Common Foundations of East Asian Success** by Peter A. Petri

The Role of Credit Policies in Japan and Korea

DIMITRI VITTAS AND YOON JE CHO



POLICYMAKERS and economists have long believed that attempts to direct the allocation of credit would not be successful. Yet the experiences of Japan and the Republic of Korea suggest that directed credit programs can increase investment provided countries have a strong institutional capacity for designing projects and appraising and monitoring performance.

Most countries worldwide have tried to direct the allocation of credit; few have succeeded. Such efforts have usually suffered from abuse and misuse of preferential funds for nonpriority purposes, increased the cost of funds to nonpreferential borrowers, involved a decline in financial discipline that resulted in low

repayment rates, and contributed to swelling budget deficits. Moreover, once introduced, directed credit programs have proved difficult to remove. The realization that these programs have frequently resulted in distorted incentives among both lenders and borrowers has led most countries to reconsider their rationale and effectiveness.

This general assessment, however, contrasts with the experience and views of government officials in Japan and Korea, who have long advocated the merits of well-managed and focused directed credit programs. According to this view, government involvement in directing credit is warranted when there is a significant discrepancy between private and social benefits, when the investment risk of particular projects is too high, and when information problems discourage lending to small and medium-sized firms. Judicious use of policy-based lending can overcome the main constraint facing new or expanding enterprises—access to external finance at reasonable terms and conditions. But to avoid the misuse of funds and the abuse of credit programs, governments need to maintain macroeconomic stability to minimize distortions in incentives and emphasize effective monitoring to ensure that loans are repaid on time. Otherwise, government failure

may exacerbate rather than correct the adverse effects of market failure.

To shed light on this debate, the World Bank recently conducted a research project on the effectiveness of credit policies, in parallel with the project on "The East Asian Miracle." The study, which focused primarily on the experiences of Japan and Korea, supports the use of credit policy, provided appropriate economic and institutional factors are put in place. The study does not prove, however, that credit could not have been obtained from private sources, although the experience of commercial banks in the late 1980s casts some doubt on the validity of this counterargument. In several countries (e.g., Japan, the United Kingdom, the United States, and the Scandinavian countries), the mistakes of private markets have led to a serious misallocation of resources.

Policies in Japan and Korea

In Japan, policy-based lending has had both industrial and social targets. The main objectives of industrial credit programs have been to promote vital industries where Japan could enjoy a dynamic comparative advantage (picking winners); help declining industries to restructure and reduce capacity where Japan was no longer internationally competi-

tive (phasing out losers); support small-scale firms; and develop the necessary industrial infrastructure. Policy-based finance has been flexible and has adapted to changing circumstances. Industrial credit policies targeted expansion of capacity in the 1950s, modernizing and upgrading technology in the 1960s, restructuring in the 1970s, and diversifying industrial structure in the 1980s.

The total size of directed credits—including those used for nonindustrial purposes—was small in relation to the total assets of the financial system (less than 15 percent). In the 1950s, industrial credit programs accounted for 30 percent of new industrial equipment funds, falling to 20 percent in the ensuing two decades and to about 12 percent in recent years. Policy-based loans involved a small subsidy, no more than 2–3 percentage points below nominal market rates, and loan losses were generally very low. Policy-based credits were mainly funded from postal savings and long-term funds. Except for the immediate postwar period, there was little recourse to central bank credit. Policy-based finance did not involve money creation and did not undermine aggregate monetary and credit control. There was also little recourse to foreign capital. Policy-based loans were administered by government development banks, such as the Japan Development Bank, with private banks playing a smaller and secondary role. Commercial banks were clearly discouraged from lending for real estate development, housing finance, and consumer credit.

In Korea, the focus of policy changed from exports of manufactured products in the 1960s to the drive for Heavy and Chemical Industries (HCI) in the 1970s and finally to the promotion of a more balanced structure, with greater support for small and medium-sized firms in the 1980s. Policy-based loans, which accounted for well over 50 percent of domestic credit in the 1970s, fell to 30 percent in the 1980s. The level of subsidies was also much greater, with real rates of interest often being negative. Central bank credit was an important source of funding for policy-based loans, as was recourse to foreign borrowing that was selectively approved and guaranteed by the authorities. Heavy reliance on central bank credit was one of the main reasons why Korea suffered from higher inflation than Japan in the 1960s and 1970s. Alongside specialized institutions, commercial banks, which were owned and controlled by the state for most of the period, were heavily involved in policy-based finance. Loan losses were higher in Korea, especially as a result of the HCI drive. In fact, the losses from this overambitious program have not yet been fully absorbed and have weakened the financial position of Korean commercial banks.

Common factors

Despite these differences between Japan and Korea, the common factors were far more important. Japan and Korea shared the way they managed and implemented policies. The governments had clear, credible, and flexible visions of the objectives of both industrial policy and policy-based finance. These visions were not imposed by politicians or bureaucrats but were the result of close and extensive consultation and coordination with the private sector and were promoted by the creation of industrial associations and the setting up of deliberative councils. These government-led industrial organizations provided an improved mechanism for risk sharing and a way of dealing with economic and political uncertainty. They also facilitated the collection and dissemination of important and relevant market information about export prospects, technological developments, and other market data to assist individual firms in their investment decisions.

The most distinguishing feature of the Japanese and Korean experience was the high degree and effectiveness of monitoring. This was greatly facilitated by the strong emphasis on exports, forcing companies to lower operating costs to internationally competitive levels. Further, export performance was easy to measure and therefore monitor. In Japan, loan approval was based on a very detailed appraisal of the projects to be financed and an evaluation of the history and character of the firm involved. The aim was to ascertain borrowers' ability to repay their loans. Independent and powerful appraisal departments were established, separate from loan departments. Once projects were approved, no payments were made without adequate documentation, while close cooperation between development and commercial banks ensured continuous monitoring of borrowers' performance and allowed development banks to take early action to recover overdue loan payments.

In Korea, loan approval was also based on detailed appraisals and checks to ensure that credit was used to finance approved investment projects and not diverted to other uses. Monitoring was reinforced by monthly export promotion meetings and by briefings on economic trends that reviewed the performance of individual sectors and firms and provided guidance for future activities. To make sure that its goals—primarily with regard to exports—were met, the government rewarded successful firms with more credit and reduced credit to less successful firms.

An important similarity between Japan and Korea that affected the success of their policies was that private firms in both countries dominated the industrial sectors. There were few national monopolies, and domestic prod-

uct markets were characterized by strong rivalry and competition among private firms.

Contribution to growth

Were the attempts by governments to direct the allocation of credit a positive force in accelerating growth in Japan and Korea? An econometric study of Japan's industrial credit programs that focused on general machinery, electrical machinery, and precision instruments during the 1980s—sectors selected because of their high potential for spillover effects due to innovation and learning—showed the following:

- Lending through autonomous government development banks had a large, positive, and statistically significant impact on firm investment: a 1-yen increase in debt from government sources led to more than 2 yen of additional cumulative investment in fixed capital assets within a three-year period;

- A 1-yen increase in debt from government sources generated an additional 5-yen increase in debt from private sources within the same time span;

- Credit from government sources was earmarked for firms with high sales growth and high expenditure on research and development (double that of firms not receiving government credit) and were thus most likely to grow, innovate, and generate technological spillover effects.

Similarly, a study on Korea showed that credit policies were effective in lowering the cost of funds and enhancing access to funds in priority sectors. Exports and heavy and chemical industries had considerably lower borrowing costs and better access to credit than other sectors, owing to the extensive emphasis of Korean credit policies on investment in equipment and physical capital. This emphasis contributed to the rapid expansion of Korean industry and the growth of manufactured exports. The output of HCI increased from 8 percent of GDP in 1970 to 18 percent in 1990, while the contribution to exports rose to 51 percent from 13 percent over the same period. Policy-based finance supported export growth, which was the main engine of economic growth in the 1960s and 1970s.

Ingredients of success

These studies support the claim of Japanese and Korean officials that credit policies can be effective under certain circumstances. The experience of these countries suggests that for credit policies to work (i.e., to achieve their objectives while causing few distortions in incentives and avoiding big loan losses), they must be

- narrowly focused and limited in scale and duration;

- based on prudent methods of financing to avoid macroeconomic instability. In particular, recourse to central bank credit must be avoided, except in the very early stages of development when selective credit programs supported by central bank credit might help jump-start economic growth and development. But even in these cases, care must be taken to prevent high rates of inflation and loss of macroeconomic stability;

- able to overcome the external finance constraint facing small or rapidly expanding firms and provide access to long- or short-term finance

for well-defined purposes, although interest rate subsidies should be kept to a minimum;

- used for "functional" purposes (such as to promote exports or acquire new technology) rather than for preferred sectors. If provided for particular sectors, clear time limits need to be set;

- channeled through financial institutions with adequate capitalization and administrative capability in appraising projects and monitoring performance. Professional management and managerial independence and autonomy are essential;

- based on clear, objective, and easily monitored criteria. Detailed project appraisals, close supervision of disbursement, and monitoring of performance and repayment records are key to the success of such programs;

- operated as part of a fundamental, but flexible, strategy of industrialization based on internationally competitive operations;

- supported by effective mechanisms for communication and consultation between the public and private sectors, including the collection and dissemination of basic market information; and

- part of a longer-term strategy to develop a sound financial system operating on commercial criteria.

Replicating the success of Japan and Korea may not be easy. Other countries must ultimately develop a cluster of policies with tools consistent with their institutional capacity. ■



Dimitri Vittas
Greek, is a Principal Financial Specialist with the Financial Sector Development Department of the World Bank. He holds an MSc in Economics from University College London.



Yoon Je Cho
Korean, was a Senior Financial Economist with the Financial Sector Development Department of the World Bank and is currently with the Korea Tax Institute. He holds a PhD in Economics from Stanford University.

This article is based on "Credit Policies: Lessons from East Asia," which summarizes the findings of the research project and contains references to other papers produced by the project.

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Are Growth Strategies in East Asia Relevant for New Zealand?

JONATHAN D. OSTRY

SHOULD New Zealand employ selective government interventions to boost its growth rate?

Evidence strongly suggests that government-induced distortions, rather than enhancing growth, actually detract from it. Hence, New Zealand's "neoclassical" approach to restructuring its economy may indeed be the one most conducive to raising its long-term growth rate.

Economists have long debated the proper role of government intervention in the growth process. Since the mid-1980s, New Zealand has been at the forefront in implementing a "neoclassical" approach to economic restructuring. Successive governments have been engaged in a broad-ranging economic reform program that involves liberalizing key sectors of the economy, reducing trade protection, and trimming the public sector. Yet growth performance in recent years has been rather lackluster. By contrast, some (but by no means all) of the dynamic Asian economies have at times adopted a more interventionist stance to promoting growth (see preceding articles based on the "East Asian Miracle" project).

Which approach works best, in the sense of raising a country's long-term growth prospects? Put in terms of the policy options

facing New Zealand, is the lesson from East Asia that the neoclassical approach alone does not work and, therefore, that New Zealand ought to rethink its strategy of economic liberalization, adding to it the type of selective policies that have apparently worked in the dynamic Asian economies?

A number of recent empirical studies by the IMF, the World Bank, and outside academics show little evidence that government intervention is linked to superior growth performance. If anything, the studies suggest that *less* intervention in the economic arena (i.e., more liberal trade and industrial policies) is strongly correlated with growth. This would imply that a rethinking of the policy approach adopted in New Zealand is not warranted and that the slow response of New Zealand to the pro-growth economic reforms is likely to reflect other factors.

The East Asian model

In the dynamic Asian economies, it is often alleged that governments have been more successful in using intervention to promote growth. Indeed, government policies (including trade and industrial policies) are often credited as a major factor behind their phenomenal growth performance. According to this view, a number of these economies (including Japan, the Republic of Korea, and Singapore) have at times adopted policies that

have favored some sectors at the expense of others. Allegedly, these governments' success at "picking winners" has been reflected in these countries' high growth rates.

How valid is the view that selective government interventions helped to boost growth in the dynamic Asian economies? When economists look at the factors accounting for growth, they do not usually think of selective industrial and trade policies as being of first-order importance. In the standard neoclassical growth theory, for example, an economy's long-run growth rate depends only on the exogenous rate of technical progress. Along the transition to the long run, the growth rate depends on the initial level of national income relative to the steady-state level, and policies can influence the growth rate temporarily by affecting the steady-state income level. In more recent studies of endogenous growth, policies (including trade and industrial policies, and public investment in infrastructure and education) can theoretically affect the productivity of factors in the steady state, and thereby directly alter the long-run growth rate of an economy.

A number of common factors help to account for the exceptional performance of the dynamic Asian economies. These include high domestic savings and investment rates, an emphasis on educating and upgrading the





skills of the labor force, the relative flexibility of domestic labor markets, and historical accidents, such as the unusual opportunity to import foreign technology and production methods.

The case that selective government interventions played a major role in the development of these countries is, however, much more difficult to make, precisely because there were very major differences in the nature and scope of such interventions across countries. Hong Kong, for example, is an obvious example of a *laissez-faire* economy, whose growth performance ranks on a par with that of the other East Asian economies over the last 30 years. Others, such as Japan and Korea, are often seen to have been much more interventionist, but the extent of intervention does not appear to be correlated with superior performance.

Several studies, moreover, suggest that the perception that government intervention is correlated with East Asia's superior economic performance is not borne out by facts. A recent study by the Australian Industries Commission concluded that "it is naive to argue that the success of Japan and the dynamic Asian economies can be explained principally by governments providing industry-specific assistance." If anything, the report concludes, where success was observed, interventions broadly conformed to the market and were short-lived.

What is the empirical verdict?

A number of econometric studies shed light on the link between government intervention and growth. A recent IMF study by Malcolm Knight *et al* shows that more openness (defined as lower tariffs on imports of interme-

diate and capital goods) stimulates productivity growth. The authors argue that because the tradable sector in many countries serves as a vehicle for technology transfer through the importation of capital goods, this result is not surprising. Their analysis also shows that the productivity of physical investments increases with the degree of openness.

A study by Jong-Wha Lee finds that trade distortions tend to lower growth directly and also indirectly by reducing investments in physical capital. This study thus concludes that countries with less distortive trade and industrial policies have tended to grow faster. Finally, a study by Vinod Thomas and Yan Wan finds a negative association between relative price distortions and economic growth in a sample of ten Asian countries. Moreover, the effect of a lower level of distortions was significant, accounting for two fifths of the variation in per capita income growth and one fifth of the variation in total factor productivity growth.

The above evidence suggests that, controlling for other factors, government-induced price distortions in these countries are lower than the average for both developed and developing countries. In addition, the authors observe that although growth was impressive in the 1960s and 1970s—when relatively more interventionist policies were adopted—it was even more remarkable in the 1980s after market reforms swept the region. The gap between average income growth in the Asian countries and other developing regions roughly tripled in size after 1982 compared with the period before. Thus, the evidence clearly points to a more liberal environment—rather than greater government inter-

vention—as being responsible for improved growth performance.

An examination of Korea's experience by Jong-Wha Lee also reinforces the above conclusions. Lee examines the relationship between selective government interventions and sectoral factor productivity growth in a large cross section of Korean industries. He finds that government interventions, such as tariffs, import restrictions, and subsidized credits, *decreased* both labor productivity and total factor productivity in the favored sectors. The results show that growth and technical progress would have been higher had the government reduced the amount of selective interventions.

Lee's evidence, in particular, illustrates the intrinsic difficulty of picking winners. Although it is theoretically possible to raise productivity growth by protecting a few well-chosen industries, Lee's findings clearly illustrate the mistakes governments are prone to make in granting selective incentives. In addition, such incentives are likely to make firms operating in the protected sectors less efficient, by decreasing competition—both domestic and international. Finally, Lee's study reinforces the results of surveys that show that Korean import-competing manufacturing firms strengthened their efforts to improve quality and productivity only after the government liberalized imports of the same products.

New Zealand's experience

During the three decades leading up to the economic reforms of the mid-1980s, New Zealand had one of the most heavily protected and regulated economies in the Organization for Economic Co-operation and Development (OECD). Tariffs were high and import licensing and quotas pervasive, resulting in some sectors receiving effective rates of protection that were extremely high by any standard, in some cases ranging more than 200 percent. In addition, the government was actively involved in propping up a number of loss-making commercial activities through regulatory interventions and subsidies. It is also during this period that many of the so-called "think big" projects were initiated, which have left New Zealand with a heavy burden of external debt. Finally, institutional arrangements in the labor market, as well as being conducive to government interference, tended to produce wage settlements that had more to do with maintaining living standards and avoiding industrial conflicts than with the underlying economic conditions in affected enterprises.

This period of extensive government intervention was also one of relatively poor growth

performance in New Zealand. For example, annual per capita income growth over 1950-85 was 1.4 percent, roughly half the OECD average. Moreover, the *sources* of growth in New Zealand were quite different from those in the leading OECD economies (the United Kingdom, United States, Germany, France, and Japan), with growth in factor inputs—as opposed to growth in efficiency or total factor productivity—accounting for over two thirds of New Zealand's expansion compared to less than one half in leading OECD countries.

Thus, prior to the initiation of reforms, growth performance in New Zealand was poor in comparison to other rich countries. Indeed, this might be expected since, in a highly protected economy, the forces of domestic and international competition—so essential to improvements in economic efficiency—are relatively weak. Combined with rigidities in labor and goods markets, the result is likely to be a very poor allocation of resources, with investments not necessarily flowing to sectors where their productivity would be greatest. This was indeed the case in New Zealand prior to 1985, when enterprises had relatively little incentive to control costs and improve the efficiency of production.

The economic restructuring program initiated by the newly elected Labor Government in late 1984 was broad-ranging. Initially, the finance, communications, and transport sectors were deregulated; agricultural subsidies and export assistance were cut sharply; border protection was reduced; and a free trade agreement was concluded with Australia. Other reforms included privatization of state-owned enterprises, corporatization of government departments providing commercial services, tax reform, and a number of measures to improve the accountability and efficiency of government operations. The result was a complete turnaround from the pre-reform period, including very sharp reductions in government assistance to pastoral agriculture, the creation of one of the least-distorting tax systems in the OECD area, and great strides in the area of trade reform, with effective rates of assistance to industry declining from 37 percent in 1985-86 to around 19 percent in 1989-90.

The reforms, however, were not associated with a turnaround in employment and growth. In some sense, though, this was to be expected. As the experience with market liberalization has since shown in a number of other countries, the process of structural change—that is, of reallocating resources from declining sectors to newly profitable sectors—can be quite lengthy, particularly if distortions are initially large and the credibility of the government is initially low.

But other factors were clearly also at work, including the restrictive macroeconomic policies that were adopted to reduce inflation. The tightness of monetary policy, in particular, led to increases in interest rates and the exchange rate, which put pressure on the tradables sector. In addition, a number of factors were beyond New Zealand's control, such as reduced access of agricultural exports to industrial country markets and escalating support for farmers in most OECD countries and many developing ones.

Another important factor that is likely to have contributed to New Zealand's lackluster growth performance in the post-reform period is the considerable delay in implementing effective labor market deregulation. It was not until May 1991 that the Employment Contracts Act, which significantly lowered work-practice rigidities and thereby helped to



Jonathan D. Ostry
from Canada, is an
Economist in the IMF's
Research Department. He
received his PhD from the
University of Chicago, as
well as degrees from the
London School of
Economics, Oxford
University, and Queen's
University.

create one of the most deregulated labor markets in the OECD, was introduced. Because labor market deregulation is clearly crucial for increasing the economy's responsiveness to the incentives created by the removal of relative price distortions, its passage only six years after the initiation of reform in the mid-1980s should be viewed as a key factor in accounting for the subdued response of aggregate output.

Lessons for New Zealand

Contrary to common perception, the message from a number of these empirical studies, as well as from New Zealand's own experience with interventionist policies, is that more liberal trade, industrial, and credit policies—rather than greater government intervention—are linked to stronger growth performance. Indeed, since the nature and scope of interventions have varied so widely among the dynamic Asian economies, it would be difficult to attribute to this factor alone a central role in these countries' growth performance.

These conclusions suggest that the reorientation of macroeconomic policies and struc-

tural reforms pursued by the government of New Zealand are precisely those that, in due course, are most likely to improve the economy's growth prospects. Of course, long lags are to be expected in response to the far-reaching reforms that have already been undertaken, particularly when one considers that credibility of policy changes is not achieved immediately and that there are large costs associated with the resource shifts to be elicited from the reforms. In particular, the last crucial piece in reforming the labor market is really quite recent, and the experience of other countries suggests that the improvement in economic performance that should result from these reforms does not occur overnight.

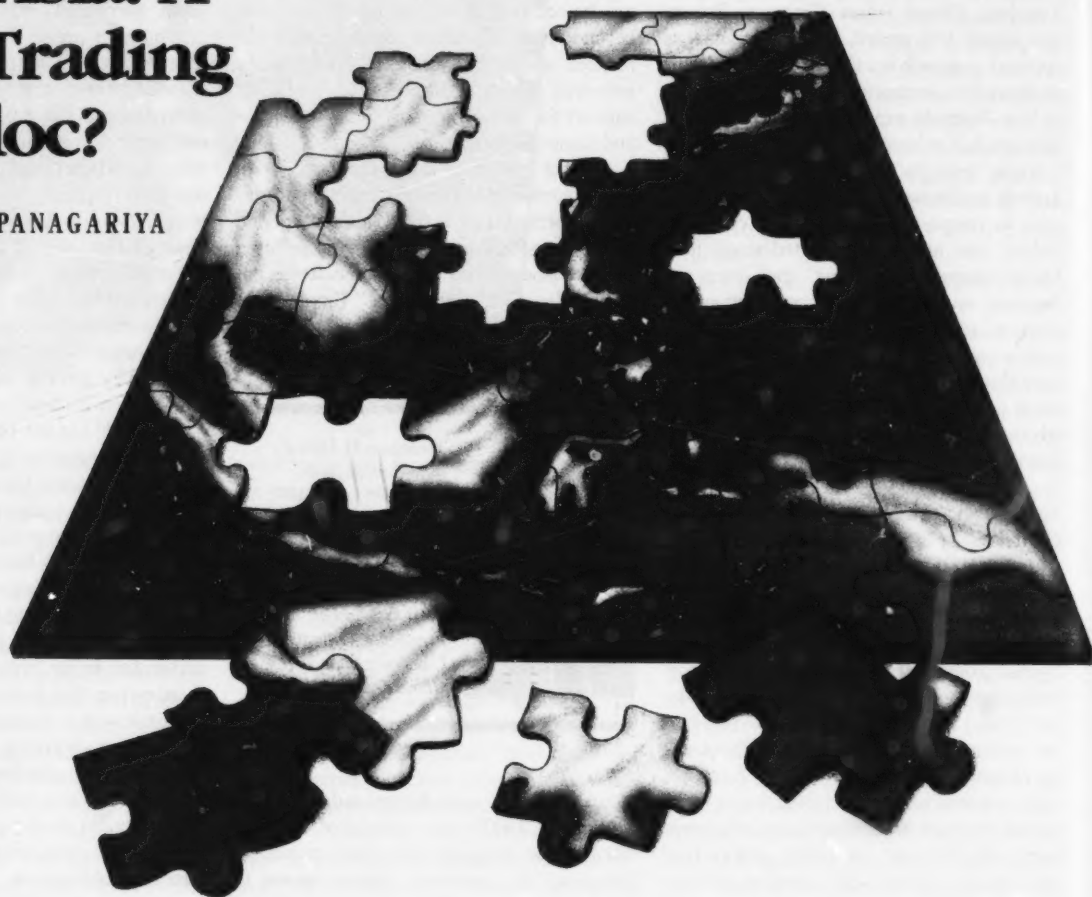
Future growth performance will also be influenced to an important degree by increasing investments in human and physical capital in order to achieve higher total factor productivity growth. Indeed, if one looks to history, New Zealand's relatively poor growth performance has not been due to a failure to increase the quantity of its productive factors (labor and capital), but rather to a failure to increase the efficiency of their use. In the past, most of the blame could be attributed to high levels of protection, factor and product market rigidities, highly distortionary tax systems, and high and variable inflation rates. In this sort of environment, investment was often undertaken in the "wrong" sectors, that is, in those sectors that were artificially favored by the distortions in the economy.

The previous system of labor relations and the wage-setting mechanism compressed relative wages across skill levels, discouraging human capital development and leaving a relatively high proportion of workers with no formal qualifications. New labor arrangements emerging in the wake of reforms have increased the rewards for skills and will encourage investment in human capital. Again, however, time will be needed to redress the skill deficiencies of New Zealand's labor force. To facilitate this adjustment process, the government has moved to make the education system and worker training programs more responsive, effective, and relevant. ■

For further detail and references to the empirical studies, see "Selective Government Interventions and Economic Growth: A Survey of the Asian Experience and Its Applicability to New Zealand," by the author, IMF Paper on Policy Analysis and Assessment, PPAA/93/17.

East Asia: A New Trading Bloc?

ARVIND PANAGARIYA



DURING the last three decades, East Asia has become one of the world's most important economic regions. With the creation of trading blocs in North America and Europe, policy advisors are beginning to ask whether it is time for East Asia to form such a bloc as well. One economist's answer to this question is "probably not."

Trade has been the undisputed engine of growth for virtually all the postwar East Asian economies. The annual growth rate of Korean exports has remained in the double digits, reaching a phenomenal 34 percent in the 1960s and 23 percent in the 1970s. In the 1980s—when

world trade grew more slowly than in the previous two decades—China, Korea, Malaysia, Taiwan Province of China, and Thailand saw their exports grow by more than 10 percent annually.

In 1967, six East Asian countries made the first (and only) attempt at regional integration, forming the Association of South East Asian Nations (ASEAN). The goal of the six countries—Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand—was to promote intraregional trade through preferential trading arrangements among member countries. But the results have been less than spectacular: intraregional trade as a proportion of total trade among the ASEAN 4 (see box) grew from 3.2 percent in 1980 to just

There are ten major players in East Asia: the ASEAN 4—Indonesia, Malaysia, the Philippines, and Thailand; the newly industrializing economies (NIEs)—Hong Kong, the Republic of Korea, Singapore, and Taiwan Province of China; and China and Japan. In addition, numerous small countries—for example, Brunei, Cambodia, and Viet Nam—also have a part in the region's burgeoning economy.

4 percent in 1990. Of this small amount of intraregional trade, not even 5 percent was covered by preferential trading agreements.

Recently, the North American Free Trade Agreement (NAFTA), the continuous widening and deepening of the European Union (EU)—previously the European Community (EC)—and the protracted negotiations at the Uruguay Round have rekindled interest in regional groupings in East Asia. On January 28, 1992, the ASEAN countries signed a framework agreement to create the ASEAN Free Trade Area (AFTA) by 2006. Policy advisors are beginning to ask a more ambitious question: should East Asia, too, form a region-wide trading bloc of its own?

On balance, both economics and politics are against a discriminatory trading bloc in East Asia. Historically, East Asia has benefited greatly from an open world trading system. Despite a redirection of trade toward itself in recent years, the region still ships two thirds of its exports to the rest of the world (Table 1). Almost without exception, studies of the newly industrializing economies (NIEs) draw

a direct connection between growth in exports and growth in GDP. China, Indonesia, Malaysia, and Thailand have been repeating the experience of the NIEs.

Given the importance of open markets to the region's economic growth, the case for an East Asian bloc should be evaluated primarily in terms of the impact such a bloc would have on the world trading system. The region's future interests will be best served by a strategy that promotes an open world trading system. A discriminatory trading bloc does not fit that bill.

Is there a role for an alternative form of regionalism in East Asia? An approach that encourages regionwide trade liberalization on a nondiscriminatory basis may still hold some promise. In the long run, this approach could serve as a stepping stone for Japan and China to assume a leadership role in promoting global free trade similar to that played by England in the 19th century and the United States in the postwar era. Unfortunately, such liberalization is unlikely, because of short-term adverse effects on the region's terms of trade.

East Asia today

The countries in the region are at very different levels of development. Japan, with a per capita income of \$23,800 in 1990, is the richest (Table 2). Per capita incomes in the remaining countries range from a low of \$327 in China to \$11,490 in Hong Kong, with the NIEs enjoying significantly higher levels than the ASEAN 4. Of the NIEs, Singapore and Hong Kong have higher per capita incomes than Korea and Taiwan, while Malaysia and Thailand have the highest incomes of the ASEAN 4 countries.

As well as being the region's richest, the Japanese economy is by far the largest. In 1990, its share of world GDP was 13.2 percent; within East Asia, its share was approximately 70 percent. Without Japan, East Asia's share of world GDP drops from one fifth to one twentieth. China lags behind Japan but is rapidly becoming another major player in the region. Using GDP figures based on purchasing power parity (exchange rates adjusted for variations in buying power across countries) for 1990, the IMF puts China's share of world GDP at 6 percent—below Japan (7.6 percent) but above Germany (4.3 percent).

In general, trade regimes in East Asia can be characterized as open, though the level of protection varies widely across countries. In terms of trade-to-GDP ratios, the region's smaller economies are very open. Table 2 shows that exports and imports as a percentage of GDP are high for all countries except China and Japan. Singapore has by far the highest levels: in 1990, they rose to more than 100 percent. For the NIEs, the proportions are both close to 40 percent; for the ASEAN 4 as a group, more than 30 percent.

Hong Kong and Singapore are textbook examples of free trading economies, with no quantitative restrictions and low tariffs. Korea, Malaysia, the Philippines, and Thailand all but eliminated their quantitative restrictions on manufactures in the 1980s. Reductions in tariff rates were not as dramatic, and in some of these countries, especially Indonesia and Thailand, tariffs remain high. Though China has liberalized its import regime considerably since the early 1980s, its remaining formal restrictions place it among the most protected countries of the region.

The openness of Japan's trade regime has been a matter of some controversy. In terms of formal barriers, Japan's trade regime is as open

Table 2
Where East Asia's exports go

Exporter	Year	North America	Western Europe	Europe	East Asia ¹	Latin America	Africa	Middle East	South Asia
North America	1980	33.5	25.2	27.4	15.8	8.9	3.3	4.2	1.0
	1985	44.4	19.3	21.0	15.5	5.9	2.5	3.2	1.0
	1990	41.9	22.3	23.4	20.4	6.0	1.7	2.6	0.8
Western Europe	1980	8.7	67.1	71.9	2.9	2.4	7.2	5.5	0.7
	1985	11.3	64.9	69.9	3.5	1.6	6.2	6.0	0.9
	1990	8.3	71.0	74.4	5.3	1.1	3.3	3.3	0.7
Europe	1980	6.3	63.7	72.7	2.7	2.3	6.8	5.5	0.7
	1985	11.0	63.5	69.2	3.4	1.6	5.1	5.0	0.9
	1990	8.2	70.6	74.5	5.2	1.1	3.3	3.3	0.7
East Asia ¹	1980	26.0	16.8	18.9	29.9	4.1	4.4	7.4	1.8
	1985	37.8	13.6	15.5	25.3	2.8	2.2	5.1	2.0
	1990	31.9	19.8	20.7	32.3	1.9	1.6	3.0	1.5
Latin America	1980	27.6	26.5	35.1	5.4	16.6	2.7	1.9	0.5
	1985	35.8	25.9	30.4	7.1	12.1	3.7	3.0	0.7
	1990	22.9	25.3	27.6	10.3	14.0	2.1	2.4	0.4
Africa	1980	27.4	49.8	46.1	4.3	3.2	1.8	1.7	0.3
	1985	14.8	64.9	69.3	1.8	4.2	5.1	2.2	0.7
	1990	3.0	66.0	68.0	4.6	0.6	12.8	4.4	3.6
Middle East	1980	11.5	40.3	41.5	20.7	5.0	1.5	4.1	2.5
	1985	6.2	15.0	17.7	1.5	0.9	1.4	8.7	0.4
	1990	17.9	48.8	53.0	9.1	1.2	3.8	8.5	0.9
South Asia	1980	15.9	24.8	38.1	14.5	0.5	6.6	14.5	5.6
	1985	16.4	20.8	37.0	16.4	6.4	4.6	11.0	4.4
	1990	17.1	30.1	46.4	18.3	2.3	2.7	6.5	3.2

Sources: UN Comtrade data.

¹ Does not include China due to a lack of data for 1980 and 1985.

East Asian countries are a diverse group

(economic indicators, 1990)

	GNP per capita (dollars)	Share in world GDP	Share in world exports (percent)	Share in world imports (percent)	Export- to-GDP ratio
ASEAN 4					
Indonesia	659	1.23	2.72	2.90	32
Malaysia	1,370	0.48	0.90	0.85	24
Philippines	730	0.30	0.27	0.38	20
Thailand	1,420	0.36	0.72	0.99	29
NIEs					
Singapore	6,650	2.10	8.09	7.96	44
Hong Kong	11,160	0.19	1.85	1.81	152
Korea	11,490	0.27	0.91	2.46	40
Taiwan Province of China ¹	8,440	1.06	2.03	2.07	27
	7,660	0.70	2.10	1.56	43
China	370	1.84	1.95	1.56	17
Japan	25,430	13.20	9.00	6.80	10
East Asia	2,630	18.26	20.35	19.27	16
East Asia (excluding Japan)	775	5.05	11.38	12.37	32
United States	21,790	24.18	11.65	15.37	7
Germany	22,320	6.67	12.46	10.17	27

Sources: 1989 and 1990 World Development Reports; Bank Economic and Social Database (BESD), World Bank.

¹ Data for Taiwan Province of China were not available in the World Development Reports; therefore, data from BESD were used.

as those of other industrial countries. There are virtually no quantitative restrictions on manufactures, and tariff rates are low. Yet Japan's import-to-GDP ratio is well below those of other countries of comparable size and with similar income levels. This fact has led some observers to argue that Japan's markets are protected by informal trade barriers and are thus relatively closed to outsiders.

A discriminatory bloc?

While proponents of a discriminatory bloc resembling NAFTA or the EU argue that economics favors their position, detractors claim that both economics and politics are against such a bloc. The detractors may be closer to the truth.

What about economics? The economic desirability of an East Asian trading bloc depends on two factors: the effects on real incomes in member countries (taking the world trading system as a given) and the effects on the incomes resulting from the bloc's impact on the openness of the trading system. Because the second factor is the more significant for large regions such as East Asia, an East Asian bloc must be evaluated primarily in terms of its impact on the global trading system. Advocates of such a grouping can offer two supporting arguments.

First, an East Asian bloc may serve as a deterrent to the formation of closed trading blocs around the world. According to this argument, the world is already dividing into

blocs. To ensure that they do not become overly protective of and limit access to their own markets, East Asia should be united and in a position to retaliate. Unilateral actions such as those taken by the United States under its Super 301 provisions, for instance, would be harder to implement with a united East Asia.

Second, the formation of regional blocs could facilitate future rounds of the General Agreement on Tariffs and Trade (GATT). The Uruguay Round was protracted in part because of the large number of participants and the "free rider" problem such a number generates. One reason for the success of past GATT rounds was that the United States could deal with the EC as a single unit. This fact has led many to conclude that a small number of blocs could make future GATT negotiations more manageable. Such blocs would also assume responsibility for many intraregional trade issues, so that the GATT process could be used primarily to resolve problems between regional trading areas—and to bring down barriers—swiftly and efficiently. Thus, the EU, an East Asian bloc, and an extended NAFTA could speed up the opening of global markets.

Both of these arguments have merit but are highly contentious. Critics note that blocs enjoy more market power than individual countries, so that, in principle, nothing prevents blocs from raising rather than lowering trade barriers. As a deterrent, then, blocs func-

tion only as long as they do not carry out the threat to raise barriers. Once the threat is carried through and a trade war breaks out, retaliatory actions are likely to be more severe than they would be without blocs.

In addition, critics note that small numbers do not necessarily mean faster progress in trade talks. The EC process that began in 1957 is still working toward a Single Market. In the meantime, the region's nontariff barriers have proliferated: the coverage of these trade restrictions expanded fivefold between 1966 and 1986.

Is a bloc politically feasible? As these arguments indicate, the economic desirability of a trading bloc in East Asia is difficult to assess. But its political feasibility—or lack thereof—is more predictable.

Internally, there are at least three interrelated factors working against a regionwide free trade area (FTA). First, the major players in the region have historically been political rivals. Though time, trade, and intraregional investments have gone a long way toward bringing these former enemies closer, the countries do not appear ready to unite in an FTA. In this respect, the situation in East Asia differs fundamentally from, for instance, Western Europe after World War II. Then, with US support (offered for economic as well as geopolitical reasons), Europeans were able to conclude treaties establishing the European Coal and Steel Community and later the European Economic Community. No similar influences are affecting East Asia today.

Second, the East Asian countries have very different levels of protection and are at very different stages of development, suggesting that the distribution of gains from an FTA would be uneven. The poorer and often more protected countries would be likely either to lose more or to gain less than their relatively open and richer counterparts. In an FTA, each member eliminates tariffs against other members but not against outsiders. Under such a scheme, members' gains accrue largely from preferential access to each other's markets rather than from domestic liberalization. By definition, the high-tariff countries give a greater margin of preference than they receive from their low-tariff counterparts and so gain less. This unevenness in gains raises the issue of compensation, a barrier not easily overcome.

Third, East Asia comprises a large number of countries, making negotiations for an FTA a daunting task. It has been difficult for the ASEAN countries to make progress with just six members. For 25 years, despite many efforts, success in promoting trading was minimal. Although the upsurge of interest in regionalism in North America did lead the ASEAN countries to sign the framework

agreement for AFTA, serious preferential liberalization has not even begun. Considering this background, it is not clear how disparate countries such as China, Japan, Korea, and the members of ASEAN can be expected to form a regionwide bloc.

The external factors at work against an East Asian FTA are even more formidable. Because many countries view Japan's markets as closed to outsiders, for the last 20 years the United States has repeatedly made Japan the target of unilateral policy actions, including voluntary export restraints, structural impediments initiatives, and Super 301 threats. Countries in the region that have relatively small economies, such as Korea and China, not only face an environment hostile to an East Asian FTA but also are vulnerable to retaliatory actions by the United States. In 1990, Korea and China both sold a quarter of their exports to the United States. Considering the extent of this trade, these countries face immense risks in supporting a bloc that could divert trade from the United States.

From the viewpoint of the smaller economies, this external environment is quite different from what Mexico faced in the NAFTA negotiations. The United States is unlikely to retaliate against its negotiating partner, and Mexico is not very vulnerable to retaliatory actions by other countries. In 1990, Mexico exported 71 percent of its goods to North America; only 13 percent went to Western Europe and just 6 percent to East Asia—1/2 of 1 percent of total imports for these two regions.

A case for open regionalism . . .

A discriminatory bloc is not a very feasible proposition in light of the above arguments, but there is another regional approach—centered around GATT-style, nondiscriminatory liberalization—that could be considered. Using this approach, the East Asian countries would come together at a common forum and, in the spirit of the GATT rounds, negotiate reductions in trade barriers. Any concessions one country made to another would automatically be extended to all members.

Several arguments can be offered in favor of this approach. First, because trade liberalization would be nondiscriminatory, there would be no trade diversion. One important objection to a discriminatory bloc would be removed: countries with high initial tariffs would not feel threatened by liberalization, since the consumers inside these countries would be the winners.

Second, this type of regionalism would not face a serious challenge from the United States, for nondiscriminatory liberalization would also improve US access to East Asian

markets. Indeed, the negotiations could go a long way toward resolving US complaints about the lack of openness of East Asian markets in general and of China's and Japan's in particular.

Third, because liberalization would take place simultaneously in all the major countries of the region, short-run adjustment costs would be minimized. In true GATT style, liberalization would take place in areas of mutual interest. Therefore, export prospects would improve for all countries at the same time that import-competing industries were exposed to more foreign competition.

Fourth, during the last decade, the United States has become what the economist Jagdish Bhagwati calls a "diminished giant." As the United States has diminished in relative economic importance, the East Asian countries, particularly Japan and China, have emerged as major global economic powers. While other parts of the world have suffered from severe



Arvind Panagariya
Indian, was a Principal Economist in the Bank's Trade Policy Division and is a Professor of Economics at the University of Maryland. He earned his PhD from Princeton.

recession, this region has grown at healthy rates. Gradually, commensurate with their current economic weight and future potential, Japan and the greater China region (including China, Hong Kong, and Taiwan) could become the leaders in global economic affairs. Japan has already emerged as one of the world's most important donor countries, and China is rapidly becoming a driving force in Asian growth. According to a recent World Bank report, greater China has become the world's "fourth growth pole" after Europe, North America, and Japan.

. . . and against

These long-term gains make nondiscriminatory liberalization an attractive option. Unfortunately, the short- to medium-term economic effects of this approach are unfavorable, for several reasons.

First, because existing tariff levels, at least in Japan, are relatively low, potential gains from lowering this most transparent trade barrier are limited. Japan also gives extensive

trade preferences to its East Asian trading partners under the Generalized System of Preferences (GSP). For example, 88 percent of the Japanese tariff lines for Korean goods are either at zero or below the most-favored-nation level; for approximately two thirds of the tariff lines, the GSP gives Korea duty-free access. A similar pattern applies to other East Asian countries. If Japan were to lower its tariffs in a nondiscriminatory fashion, these developing countries would lose the tariff preferences they currently enjoy.

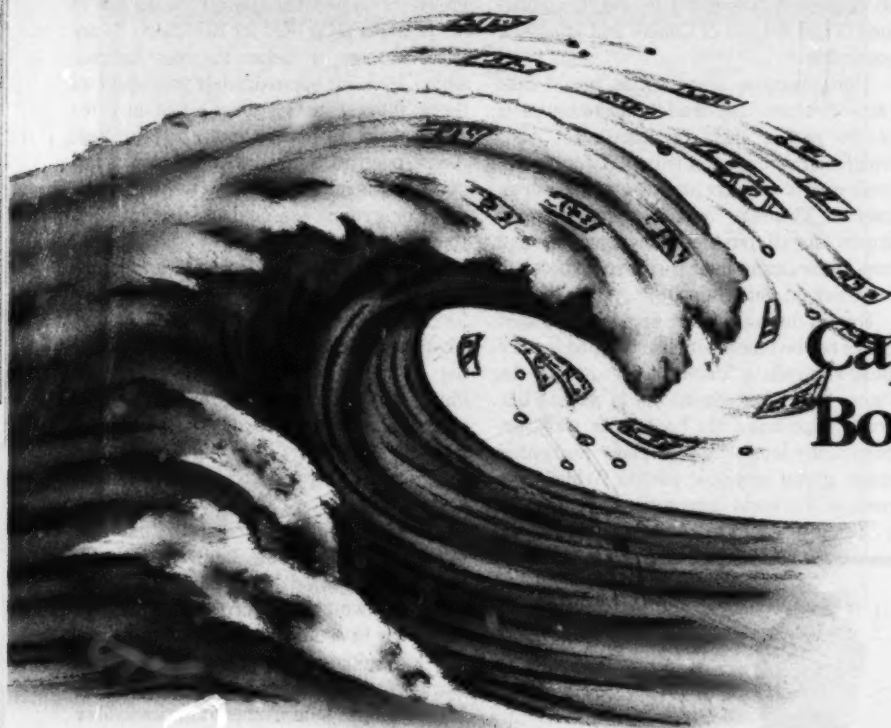
Second, because tariff levels across the other countries are highly variable, the scope for negotiating reduced barriers is limited. Thailand, Indonesia, and arguably China have the highest tariff levels; Korea's and the Philippines' are moderate (generally below 20 percent); and Singapore and Hong Kong are virtually tariff-free. Given this varied structure, the scope for reciprocal tariff reductions is limited.

Third, in any East Asian negotiations, Japan must assume the leadership role the United States played during the GATT negotiations. But with so few formal trade barriers, Japan may have difficulty. It must either find a way to negotiate the so-called informal trade barriers or use its aid and investment leverage in the region to induce other countries to liberalize their regimes.

Finally, and perhaps most important, even if substantial trade barriers in Japan and other countries could be identified and negotiated away on a nondiscriminatory basis, the likely decline in the region's terms of trade with outside countries would be substantial. Because two thirds of the region's goods are traded with outside countries, a major liberalization would involve unilateral concessions. The GATT negotiations sidestepped this problem, as the former EC, the United States, and Japan negotiated tariff reductions simultaneously. They were able to carry out substantial liberalization without making major concessions to nonnegotiators, most of which were developing countries.

It is difficult to take an optimistic view of regionalism in East Asia. A discriminatory bloc is neither particularly desirable nor feasible. A nondiscriminatory approach could yield high returns in the long run, but because its short-term effects on the terms of trade are likely to be negative, it is an unlikely development. ■

This article is based on the author's paper, "Should East Asia Go Regional? No, No, and Maybe" (World Bank Working Paper Series 1209, Policy Research Department, Trade Policy Division).



Surges in Capital Inflows: Boon or Curse?

SUSAN SCHADLER

THE RECENT surges in capital inflows to several countries have held the promise of significantly increasing investment and growth in these countries but also can pose the threat of financial instability. To fashion an appropriate policy response, policymakers need to carefully identify the circumstances that give rise to these inflows.

The surge in capital inflows in recent years—particularly in some Asian, Latin American, and Middle Eastern countries—has led to large increases in foreign reserves, sometimes after years of tight external financing constraints, holding the potential for higher investment and growth in these countries.

But too much of a good thing can present problems. This is particularly true when the risk of reversal of capital inflows is high. Large and sudden capital inflows can fuel macroeconomic instability: rapid consumption growth, rising or sustained high inflation, an appreciating real exchange rate, and widening current account deficits. In these circumstances, policymakers have struggled to find the right balance in policies between accommodating the beneficial effects of the inflows and adequately restraining demand and prices.

To evaluate the effects of surges in capital inflows and possible policy responses, a recent IMF study (see box) looked at six countries—Chile, Colombia, Egypt, Mexico, Spain, and Thailand—that experienced surges in capital inflows during the period 1987–92. The study found that to the extent that surges in capital inflows reflected improvements in financial stability and structural policies, they were highly beneficial to recipient countries. However, when the inflows reflected more temporary developments—changes in external interest rates or unsustainable increases in domestic interest rates—policies needed to be geared toward containing possible destabilizing effects.

Factors causing the surge

The timing, persistence, and size of the inflows differed considerably among the six countries (see table). In most, there was a rather clear jump in the level of net inflows—for Mexico, Spain, and Thailand in the late 1980s and for Chile, Colombia, and Egypt in the early 1990s. The surge peaked at about 8 percentage points of GDP in Mexico and Thailand and at about 5–6 percentage points in the other four countries.

Information on the types of inflows is generally limited, but a few patterns can be detected: inflows were directed mainly to the private sector and, for most of these countries, were about evenly divided between short-, medium-, and long-term maturities; direct foreign investment accounted for 15–20 percent of the increase in the inflows in most of these countries; portfolio investment is believed to have been important in Mexico and Spain, though data are scanty; and “capital-like” inflows, stemming, for example, from workers’ remittances or other inflows through the current account, were principally important in Colombia and Egypt.

It is tempting to assume that surges in inflows are rooted in common causes, have common effects, and that policy responses can

be guided by a common formula. In fact, because the causes of inflows were varied, so were their effects. To strike the right balance between restraint and accommodation, policymakers need to carefully identify the circumstances that give rise to the inflows and their different effects on the economy.

Changes in external conditions clearly played a role in the surges in capital inflows that occurred during the late 1980s and early 1990s. Drops in interest rates and a slowing of growth in industrial countries sent capital from industrial countries looking for higher rates of return in other countries. These developments, however, did not often coincide with the surges in inflows, suggesting that other, domestic, factors must have played an important role as well.

Two types of domestic influences have been most common in attracting surges in inflows. The first concerns *changes in domestic economic policies*, including structural changes that improve potential productivity or reductions in public sector deficits that promise greater macroeconomic stability and support a real depreciation. The second is a *tightening of domestic credit policies or increases in administered interest rates*, without a corresponding fiscal adjustment. With exchange rates fixed (or on a fixed nominal path), inflows are attracted by high domestic interest rates.

Often, one or all of these influences have been augmented by "bandwagon" effects. These are difficult to identify but are assumed to reflect financial markets following fashions or overreacting to new information.

How does the effect of inflows caused by each of these influences differ? When changes in external conditions dominate, surges in inflows tend to push interest rates down, but in most other respects tend to bring the standard signs of overheating. Moreover, there is considerable potential for a reversal of the inflows when external conditions turn around.

When changes in domestic economic policies of a structural nature dominate, the visible effects are similar, but, rather than being possible causes of instability, they tend to be equilibrating and sustainable. Such effects reflect the scope for profitable investment and help channel resources toward meeting increased demand for traded and nontraded goods.

When inflows are attracted principally by a tightening of

domestic credit policies, their effects are largely confined to increasing official reserves, often thwarting the effort to lower money growth and inflation. Changes in investment, growth, and the current account are minimal. Nevertheless, because such a mix of tight money, easier fiscal policy, and a fixed exchange rate is likely to be unsustainable, the risk of reversal is high.

Inflows to each of the six countries reviewed were attracted by a mix of these influences, although the balance between each type of influence differed among the countries. At one end of the spectrum was Thailand, where sustained fiscal consolidation and changes in regional investment patterns were the principal influences on inflows, while credit policies were broadly unchanged. At the other end of the spectrum was Colombia, where, notwithstanding important fiscal and structural policy changes, a tightening of credit conditions was a major impetus to the inflows.

Policy responses

In all of these countries, the choice between allowing the inflows to stimulate demand and growth, on the one hand, and curbing their possibly destabilizing effects, on the other, rapidly became a policy issue. In principle, a careful review of the causes of the inflows should have guided policies. When surges in inflows are clearly attracted by sustainable improvements in competitiveness or potential productivity growth—so that the effects on activity, prices, and the trade balance are less signs of overheating than equilibrating adjust-

ments—the policy response could be focused on improving the absorptive capacity of the economy rather than on containing the destabilizing effects. When external influences, bandwagon effects, and even credit restraint are the more important causes of the inflows—so that the effects may be destabilizing—policies need to concentrate on containing the inflows or neutralizing their effects.

In practice, uncertainties about the balance between the various causes in each country have meant that most governments implemented policies to limit the risks of destabilizing effects. It is, therefore, not surprising that there was a wide range of responses. In Mexico, policy action was relatively subdued owing to a strong desire to stick to a predetermined course of policies and a general willingness to accept the "Lawson doctrine"—that as long as the public sector finances are in balance, gaps between saving and investment in the private sector are not a major concern. Actions were relatively aggressive in Chile, Colombia, and Egypt, where credit policies were fully dedicated to reducing inflation. Spain and Thailand occupied a middle ground: inflows were perceived as a response to fundamental changes in the economy and in its attractiveness to foreign investors, but the threat of overheating was still a major concern.

Sterilization. Broadly defined to include not only open market operations but also other means of limiting the growth of credit—such as increasing reserve requirements on all or selected bank deposits, curtailing access to rediscount facilities, or raising discount rates—sterilization is usually the first line of defense against the unwanted effects of surges in capital inflows. It can be implemented quickly and usually prevents a widening of the current account deficit while locking in large increases in official reserves, which limit a country's vulnerability to a reversal of the inflows.

Sterilization occurred on the largest scale in Chile, Colombia, and Egypt, countries where the initial tightening in credit conditions probably also played an important role in attracting the inflows. There, sterilization took the form of increases in reserve requirements and open market operations. In Colombia, the central bank shifted to a heavy reliance on the sale of foreign exchange certificates—forward foreign exchange assets bearing a market

Size of capital inflows differs considerably

	Average of three years prior to episode	Inflow episode			
		Year 1	Year 2	Year 3	Year 4
Chile (1990)	1.0	3.0	1.1	3.1	...
Percent of GDP	4.5	10.6	3.5	6.1	...
Colombia (1991)	0.4	2.0	1.3	...	...
Percent of GDP	0.9	4.8	2.7	...	...
Egypt (1991/92, July–June)	0.9	3.5	...	...	...
Percent of GDP	3.7	9.5	...	...	...
Mexico (1988)	-0.4	4.6	11.0	20.8	24.7
Percent of GDP	-0.2	2.4	4.6	7.4	7.6
Spain (1987)	-1.6	10.9	9.2	14.6	14.5
Percent of GDP	-1.1	3.6	2.7	3.8	3.1
Thailand (1986)	1.4	3.1	6.7	9.3	11.8
Percent of GDP	3.3	5.2	6.7	11.4	12.6

Source: IMF staff reports and estimates.
Note: First year of episode noted in parentheses after country name.
... indicates data not available.

interest rate in exchange for current foreign exchange receipts.

As inflows persisted, most governments reduced their reliance on sterilization. This generally occurred when the costs of sterilization—that is, the losses from issuing bonds with high interest rates while investing in foreign assets with lower interest rates—became too large. In addition, aggressive sterilization through open market operations maintains the pressure on domestic interest rates, perpetuating the conditions that attracted large inflows in the first place. Of course, by forcing foreign inflows into purchases of government bonds and sustaining high domestic interest rates, sterilization deprives the economy of the benefits of inflows—higher domestic investment and growth.

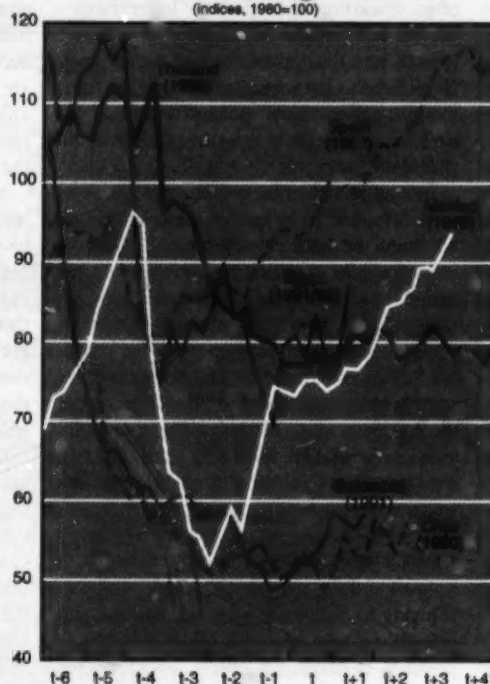
Exchange rate policy. Most of the countries reviewed maintained a fixed or broadly fixed rule for the exchange rate. Initially, the governments took the position that the sustainable real exchange rate was not significantly higher than its level before the surge in inflows. However, as the inflows pushed up or sustained inflation, real exchange rates rose (see chart). Thus, whether inflationary pressures should be pre-empted through a nominal appreciation became a policy issue.

Chile, Colombia, Mexico, and Spain resorted to nominal appreciation or a modification in the announced path for the exchange rate. Each, except Mexico, had initially responded to the surge in inflows with relatively aggressive sterilization. When it became apparent that this could not be done on a scale sufficient to reduce money growth and inflation to targeted levels, the exchange rate was adjusted.

Exchange rate action has unleashed questions about what role market forces should have in determining the change. Spain, for instance, decided to fix the exchange rate. This decision was based on the view that a market-determined appreciation encouraged speculation, posed a greater risk of overshooting of the real exchange rate, and denied a credible nominal anchor should the inflows reverse. These arguments, and the underlying objective of harmonizing with the European Community, led Spain to join the Exchange Rate Mechanism two years into its inflow episode.

In contrast, Chile and Mexico moved to greater, albeit still limited, flexibility by

As inflows pushed up inflation, real effective exchange rates rose
(Indices, 1980=100)



Source: Information Notice System, IMF.
Note: Period "Y" is the first year of the surge in capital inflows, the timing of which is indicated in parentheses after country name.

enlarging the band within which their exchange rates moved. Three considerations were important: first, the position of the exchange rate in the band could be used as an indicator of the appropriateness of the rate, which helped assuage public perception that it was overvalued; second, permitting some flexibility increased the exchange rate risk for foreign investors; and third, a reversal of inflows would elicit an immediate offsetting policy response through a change of the exchange rate in the band.

Fiscal policy. In the face of large and persistent inflows, a tightening of fiscal policy is generally the only means of containing inflation and avoiding a real appreciation. The form of the adjustment is important. Lower government expenditures, particularly on nontraded goods, directly reduce demand and therefore have a stronger effect on inflationary pressure than increases in revenue.

In fact, however, despite the strong cyclical positions of the economies reviewed, fiscal adjustment did not figure significantly in most countries' responses to the inflows. One important reason was the difficulty of garnering public support for a tightening of fiscal policy, particularly in the wake of the already significant adjustments that had occurred in most of the countries prior to the surge in

inflows. Added to this was the need in some countries for investment in infrastructure to accommodate the higher investment that stemmed from the inflows.

Thailand stands out as the exception. There, the position of the central government relative to GDP swung by over 7 percentage points from a deficit in the year preceding the inflow to the peak fiscal surplus four years later. The improvement reflected fiscal measures—particularly to contain current expenditure—and a strong cyclical improvement in revenues. In Egypt, where fiscal consolidation coincided with the first year of the inflow, efforts to contain expenditure continue, but the period of inflows is not long enough to be meaningful.

Microeconomic policies

Although the responses to surges in inflows were mainly focused on macroeconomic policies, microeconomic policies also played a role in two main ways: in some countries, the introduction of impediments to inflows or trade liberalization measures appears to have slowed down reserve accumulation for short periods; and financial sector reform and trade liberalization have increased the efficiency with which inflows are absorbed.

Impediments to inflows—taxes or quantitative restrictions on foreign holdings of domestic financial instruments—are, like sterilization, quick and easy to impose. Unlike sterilization, they preclude even future benefits of incipient inflows for investment and growth. Resort to them, therefore, usually followed efforts to sterilize and tended to reflect several considerations: a judgment that the inflows were prone to reversal and would not provide lasting benefits to the economy; concerns about the effect of sterilization on interest rates; and fears about the efficiency with which the economy could absorb inflows—because of implicit government guarantees, inadequate infrastructure, or deficiencies in the banking system. Against these considerations, however, must be weighed the threat that prolonged restrictions or taxes on inflows to the banking system weaken bank profits and encourage disintermediation. All the countries except Egypt resorted to such impediments—Chile and Spain, the most forcefully. The period over which these impediments affected inflows cannot be verified, but the experience suggests that the inflows slackened temporarily when the impediments were

imposed. However, within one year the scope of the impediments needed to be broadened several times as inflows increasingly circumvented them.

Several of the countries had longstanding distortions in the financial sector, such as weaknesses in banking supervision and prudential standards. The increase in inflows added to the urgency of addressing these problems for three reasons: inflows tended to increase the flow of funds through the banking system, adding to risky lending behavior; inflows increased banks' open foreign exchange positions, raising their exposure to exchange risks; and, although only Chile, Colombia, and Spain had explicit deposit insurance, some governments had stepped in to avoid bank failures and the risk of implicit government guarantees was substantial. To address these risks, regulations to ensure the adequacy of capital and limit banks' exposure to foreign exchange risk as well as improvements in prudential and supervisory standards are essential. In general, the countries reviewed already had reform programs in train when the surges in inflows began and these were maintained, but not accelerated, as the inflows persisted. Exceptions were Egypt and Mexico, which introduced limits on banks' open foreign exchange positions in response to the inflows.

Some countries have eased restrictions on capital outflows in an effort to lessen the buildup of reserves and to enhance efficiency by subjecting domestic financial markets to greater international competition and enabling residents to diversify their portfolios. Whether such measures actually promote net outflows is unclear. Where capital flight has been sizable, the volume of pent-up capital may not be large. Also, simplifying the process of repatriating profits and capital can attract inflows.

Most of the countries reviewed had already put in place a program of trade liberalization before the surge in inflows. Colombia, Mexico, and Thailand accelerated their programs or introduced limited new measures in response to the inflows. The initial motivation for trade reform—to improve economic efficiency—became all the more important when large inflows needed to be allocated throughout the economy. Moreover, the surge in inflows eased any perceived external constraint on the speed of trade liberalization and tariff reduction. There was a question, however, of whether an acceleration of trade reform helped contain increases in reserves. Initially, the main effect of lowering tariffs may have been to increase import demand, weaken the current account, and slow reserve accumulation. Over time, however, efficiency gains, par-

ticularly if tariff reductions affected mainly intermediate inputs, would improve competitiveness and the current account.

What were the effects?

The effects of surges in capital inflows clearly cannot be generalized; not only did countries' differing policy responses result in different effects, but also the myriad coincident developments obscure the pure effect of the inflows. Nevertheless, several broad patterns can be discerned.

First, surges in inflows tended to push down domestic interest rates—both nominal and real—once any initial thrust of sterilization subsided. Surges in prices of other finan-



Susan Schadler
a US citizen, is an
Assistant Director in the
IMF's Policy Development
and Review Department,
and holds degrees from the
London School of
Economics and Mount
Holyoke College.

cial instruments, especially in equity and real estate markets, also occurred, particularly in the Latin American countries.

Second, surges in inflows did not result in the much feared expansion in monetary aggregates. This is principally because aggressive sterilization or, when sterilization had been subdued, large reflows through the external current account curbed the monetary effects.

Third, reflecting the absence of large monetary effects, accelerating inflation was not, in general, a problem. However, in all of the countries except Thailand, inflation persistence was a problem. In other words, it proved possible to prevent surges in monetary aggregates and inflation in the face of inflows, but it was difficult to exert financial restraint and disinflate.

Fourth, real appreciations of domestic currency were difficult to avoid. Of the countries reviewed, only Thailand managed to escape a sizable real appreciation. This appears to have been the result of the country's history of low inflation together with a large improvement in the fiscal position as the inflows occurred.

Fifth, particularly when sterilization was not aggressive, as in Mexico, Spain, and

Thailand, capital inflows fed increases in current account deficits. Widening current account deficits reflected increases in investment in all of the countries, but in Mexico, also a sharp drop in the private savings rate.

Sixth, private investment rose in each of the three countries that did not sterilize aggressively, although the magnitude of this effect varied enormously: Thailand, benefiting from a major shift in regional investment and trading patterns, saw an increase in the ratio of private investment to GDP of some 7-8 percentage points over a three-year period, while Mexico and Spain experienced smaller increases of about 3 percentage points.

Final thoughts

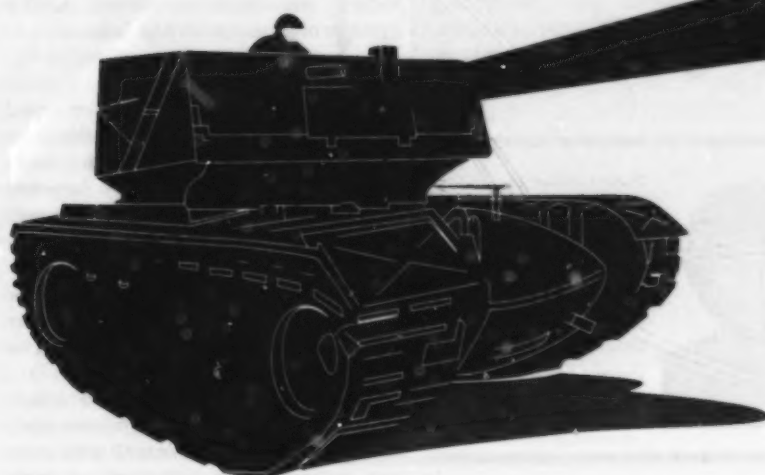
Although the enormity of surges in capital inflows has presented significant problems for macroeconomic policies, policymakers must not forget that such inflows carry the potential for important improvements in investment and potential growth. Unless inflows are caused by temporary changes in external circumstances, domestic credit conditions, or bandwagon effects, the thrust of the policy response should be on creating the conditions for inflows to be used productively.

What sorts of policies are needed to meet these objectives? Although aggressive sterilization proved unsustainable in all of the countries reviewed, some adjustment of credit policies is essential. Fiscal restraint is arguably the only means of preventing the overheating and real appreciation that typically result from surges in capital inflows. Yet the fiscal adjustment needed to stem a real appreciation in the face of a true surge in inflows is likely to be very large—perhaps even beyond the bounds of feasibility. In these circumstances, nominal exchange rates should be adjusted in a timely manner to pre-empt the inflationary impetus of the inflows. Finally, changes in microeconomic policies—particularly trade and financial reform—can contribute significantly to improving the efficiency with which inflows are absorbed. ■

For a review of the issues discussed, see "Recent Experiences with Surges in Capital Inflows," by Susan Schadler, Maria Carkovic, Adam Bennett, and Robert Khan, IMF Occasional Paper No. 108, December 1993, \$15.

Reductions in World Military Expenditure: Who Stands to Gain?

VIVEK B. ARORA AND TAMIM A. BAYOUMI

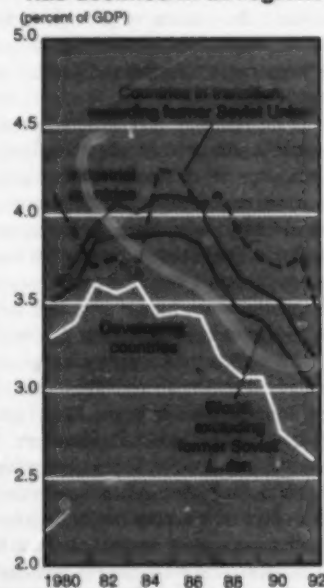


WORLDWIDE military spending relative to output has fallen significantly since 1985 in almost all regions of the world. Without taking into account the impact of such cuts on national security, an IMF study estimates that a further drop of this magnitude—about 20 percent—would offer significant long-term benefits for private investment and private consumption, especially for developing countries.

Recent changes in the world political situation, particularly with respect to the former Soviet Union, have had profound effects on the global economy. One obvious outcome is the global decline of military expenditure, which, according to IMF staff estimates, has dropped by almost one fourth, from nearly 4 percent of GDP in 1986 to 3 percent in 1992.

Although the primary impact of military expenditure is on national security, there are also important economic effects. If the declining trend were to continue, how would the different geographic regions be affected? An IMF study looked at what might happen if military spending worldwide fell by 20 percent—similar to what was experienced in the 1980s—using MULTIMOD, the IMF's world macroeconomic model. Although this relatively simple macroeconomic approach does not take into account certain factors—such as the impact of changing the composition of government spending—the results underscore the significance for the global economy of these reductions in military expenditure.

Military spending has declined in all regions
(percent of GDP)





Why spending fell

In the *industrial countries*, part of the fall in the ratio of military expenditure to GDP reflects a reversal of the buildup of military spending in the early half of the 1980s (see chart), particularly in the United States, which accounts for over half of all industrial country military expenditure. In contrast, *other industrial countries* generally show little or no military buildup in the first half of the 1980s but a significant downsizing since 1986. *Developing countries* and *countries in transition* show a pattern similar to the other industrial countries.

Among the factors that may have contributed to the cutback in military spending since 1986 are the poor growth performance in many developing countries during the 1980s and in industrial countries in the latter part of the decade. The type of government in power also appears to influence military expenditure, with democratic governments spending less on the military than other types of government. Finally, the improved global security environment and the associated fall in the level of military aid probably played an important role.

Costs and benefits

In any discussion, it is important to consider the nature of the economic costs and

benefits from cutting military spending. Although many economic analyses use real GDP, a measure of total output, to estimate welfare, it is not reliable for estimating the economic benefits of military spending cuts. Military spending provides security but few direct economic benefits to consumers. A more appropriate measure of the economic benefits from curtailing military spending is the gradual rise in nonmilitary consumption. Of course, the cost of cutting military spending includes any resulting decrease in security. But this security loss is difficult—perhaps impossible—to measure, particularly in the case of a multilateral reduction in military spending of the type analyzed here, where the loss in security from domestic cuts in military expenditure must be weighed against the gain in security from lower military spending in other countries. For this reason, this article focuses on the economic benefits but acknowledges the need to weigh them against any impact of spending cuts on national security.

Who gains and how

Suppose that all countries simultaneously carry out a 20 percent reduction in military expenditure in equal increments over five years. Over time, the cuts in government consumption are assumed to be accompanied by tax cuts that are high enough to leave the

government deficit approximately unchanged.

The results from a basic simulation are shown in Table 1. Like any reduction in government spending, the cut in military spending in the *industrial countries* initially reduces demand and, hence, the rate of growth of real GDP. However, lower government spending leads to lower interest rates as current consumption declines. In the simulation, this allows governments to decrease taxes. Lower taxes and reduced interest rates raise private sector spending on investment and consumption.

First-year military spending cuts of \$27 billion would reduce GDP by \$6 billion compared with its baseline value (all figures are in constant 1992 US dollars). The relatively small initial output loss reflects the gradual nature of the military spending cuts. Private sector expenditures are stimulated both by current reductions in government spending and by anticipated future reductions in this spending. By the second year of the simulation, the output loss is reversed as private spending continues to grow. This improvement in private spending continues, and, by the end of the eleventh year, GDP is \$60 billion (0.3 percent) above baseline; consumption is \$144 billion (1 percent) above baseline; and investment is \$83 billion (almost 2 percent) above baseline. The present value (the sum of all future gains

Impact of a 20 percent cut in worldwide military spending

	Government consumption	Private consumption	Private investment	GDP
Industrial countries¹				
Year 1	-36.5	3.7	17.2	-6.2
Year 6	-150.0	109.1	76.6	34.8
Year 11	-168.7	143.9	83.6	59.8
United States				
Year 1	-15.3	6.7	4.2	-3.1
Year 6	-67.7	50.9	23.4	8.6
Year 11	-68.8	67.0	27.3	22.5
Japan				
Year 1	-1.7	1.2	4.5	-0.4
Year 6	-6.5	13.6	13.3	7.2
Year 11	-10.3	18.3	15.0	11.5
Net other developing countries²				
Year 1	-4.2	1.7	2.9	0.6
Year 6	-24.2	16.2	15.8	8.9
Year 11	-27.2	29.0	18.6	11.9

Source: Benito Bayazit, Daniel Havell, and Steven Szymski, "The Impact of Worldwide Military Spending Cuts on Developing Countries," 64th Working Paper 63/86 (November 1993).

¹ Including four newly industrializing economies (NIEs) in Asia.

² Excluding NIEs.

discounted at a 4 percent real rate of interest) of the gain in economic welfare over all future years is estimated at \$8.1 trillion for industrial countries, or 45 percent of 1992 GDP, compared with military spending cuts with a present value of \$6.5 trillion, or 36 percent of 1992 GDP.

Separate results are calculated for the United States and Japan. In 1987-89 (the baseline period for the simulations), military spending in the United States averaged 6 percent of GDP, the largest ratio among the industrial countries. As may be expected, the short-term impact of this relatively large cut in military spending—1¼ percent of GDP after five years—is to reduce GDP below the baseline for several years. These losses in output are, however, relatively small; over the first five years, the cumulative loss in real GDP is only \$7 billion (less than 0.03 percent of GDP) compared with cumulative expenditure cuts of almost \$250 billion. After 11 years, private consumption rises by 1¼ percent, and private investment rises by 2 percent—somewhat higher than in the industrial countries as a group.

In Japan, military expenditure represents approximately 1 percent of GDP, the smallest ratio among the major industrial countries. As a result, the initial fall in output is more short-lived and mild than in the United States, but the long-run gains relative to GDP are also somewhat smaller. By the eleventh year, real consumption rises by ½ of 1 percent, and real investment by 1¼ percent relative to baseline.

Although the gains in Japan are smaller than in the United States, the difference is less than might be expected given the difference in military spending. The reason for the relatively favorable effects in Japan is that global cuts in military spending have positive international economic consequences: the economic benefits to all countries are greater when countries coordinate reductions in military expenditure than when one country reduces military expenditure unilaterally. This reflects lower world interest rates and increased volumes of international trade—trade rises because the trade component of military spending is lower than that of the private sector spending that replaces it. This can be seen in the welfare calculations in Table 2. While the present value of the gain in economic welfare in the United States is 54 percent of 1992 GDP, a significantly higher ratio to output than the 31 percent of Japan's GDP, it is considerably smaller than the differential

Present value of costs and benefits of reducing military spending in 1992¹

	First ten years	Beyond ten years	Total
Industrial countries²			
Nonmilitary consumption	3.9	40.7	44.6
Military spending	-5.4	-30.5	-35.9
United States			
Nonmilitary consumption	5.1	48.9	54.0
Military spending	-9.1	-51.2	-60.4
Japan			
Nonmilitary consumption	2.4	28.7	31.1
Military spending	-1.5	-9.6	-11.1
Net debtor developing countries³			
Nonmilitary consumption	3.2	43.0	46.2
Military spending	-5.0	-28.1	-33.2
Western Hemisphere			
Nonmilitary consumption	2.9	37.3	40.2
Military spending	-2.8	-15.7	-18.5
Africa			
Nonmilitary consumption	3.5	46.2	49.7
Military spending	-5.1	-28.2	-33.3
Other developing countries			
Nonmilitary consumption	3.2	45.4	48.6
Military spending	-6.3	-35.1	-41.3

Source: Tamim Bayoumi, Daniel Hewitt, and Steven Symanski, "The Impact of Worldwide Military Spending Cuts on Developing Countries," IMF Working Paper 93/66 (November 1993).

¹ The discount rate used in the present value calculations is 4 percent.

² Including newly industrializing economies (NIEs).

³ Excluding NIEs.

in military spending cuts.

The *net debtor developing countries* also benefit. Higher trade and commodity prices produce a rise in private consumption and investment that is strong enough to offset the contraction in government consumption, so that GDP does not fall even in the short run. The eventual increase in GDP, 11 years after the cut in military expenditure, is \$12 billion (¼ of 1 percent), whereas private consumption rises by \$23 billion (¼ of 1 percent), and investment by \$18.6 billion (2 percent). The present value of the welfare gain is 46 percent of 1992 GDP (\$1.5 trillion), slightly higher than the ratio for the industrial countries, even though the ratio of military spending cuts to GDP is slightly lower.

Net debtor developing countries gain significantly from lower world interest rates, which reduce interest payments on foreign debt. They also benefit from the boost to world trade and commodity prices caused by the replacement of military spending, which is largely spent domestically, with private consumption and investment, which have a higher import content. About one third of the welfare gains for net debtor developing coun-

tries come from the military spending cuts in industrial countries.

The experiences of developing country regions differ in interesting ways. The *Western Hemisphere* region experiences the smallest cut in military spending. At the same time, its trade is predominantly with the United States. Because the United States implements the largest cut in military spending of the major industrial countries, it also has the largest increase in demand for traded goods. As a result, the region experiences welfare gains of 40 percent of 1992 GDP—over twice the present value of the military spending cuts of 19 percent of 1992 GDP.

The cuts in military spending relative to GDP are larger in *Africa* than in the Western Hemisphere. Because Africa's trade is heavily oriented toward Europe, where military spending in relation to GDP is lower than in the United States, the boost to exports is smaller than for the Western Hemisphere, although Africa does gain significantly from the rise in commodity prices. At 50 percent of 1992 GDP, the welfare gains are the highest of any developing country region and come from military spending cuts of 33 percent of 1992 GDP.

The *other developing countries*, taken as a region, implement the largest cut in military spending. The gains to consumption and investment are, however, relatively modest owing to the regional pattern of trade. These countries are net importers from Japan and net exporters to the United States. The military spending cuts in the industrial countries cause the dollar to depreciate and the yen to appreciate. This loss in the terms of trade leads to a diversion of domestic output into exports. As a result, the welfare gain is only 48 percent of 1992 GDP, compared with military spending cuts of 40 percent.

Military expenditures in *net creditor developing countries*, primarily oil exporters, are relatively high at 7 percent of GDP. Because a large portion of military expenditure is imported, costs of conversion are probably low, and cuts in military spending are easily replaced by higher private consumption and investment. The present value of this rise in private sector expenditure is 80 percent of 1992 GDP (\$569 billion), reflecting the high level of initial military expenditure.

The sensitivity of the simulation results has been examined by running alternative scenarios with the following changes:

- faster implementation of the military spending cuts;
- failure of the private sector to anticipate spending cuts in the future;
- less forward-looking consumption and investment; and
- the assumption that a part of the military spending cuts represents a reduction in productive government investment.

The first three of these variations, which affect the short-term response of demand, tend to make the short-term reductions in GDP larger than in the base case. However, they

have little effect on the long-run equilibrium and, hence, on the welfare calculations. In contrast, if part of the cut in military spending is considered to be investment, the welfare gains are reduced appreciably, but the short-term response is essentially unaffected.

Those countries that implement the largest cuts have the largest long-term gains in consumption and investment, as well as the largest short-term losses in output. Relative to the size of the spending cuts, net debtor developing countries gain somewhat more than industrial countries, because the benefits from

lower world interest rates and increased demand for their exports are larger.

An important implication of this analysis is that military expenditure cuts in any one country have significant positive consequences for the rest of the world, both through lower interest rates and changes in real exchange rates. As a result, the distribution of the economic benefits is considerably more even than the distribution of the cuts, reinforcing the conclusion that there are economic, as well as security, reasons for coordinating military expenditure cutbacks. Cutting military spending by 20 percent worldwide could, over the long run, increase private consumption by about 1 percent and investment by about 2 percent. These gains, in turn, would produce the major share of the rise in economic welfare. ■



Vivek B. Arora
an Indian national previously with the IMF's Research Department, is a participant in the Economist Program in the IMF's Central Asia Department. He was educated at St. Stephen's College, Delhi, and Brown University.



Tamim A. Bayoumi
a UK citizen, is an Economist with the IMF's Research Department. He has a PhD from Stanford University.

This article is based on "Economic Benefits of Reducing Military Expenditure," Annex II, World Economic Outlook, October 1993, IMF, by Vivek Arora and Tamim Bayoumi.

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Is Wide Variation in Petroleum Prices and Tax Rates Warranted?

SANJEEV GUPTA AND WALTER MAHLER

Deputy Division Chief, Fiscal Affairs Department, IMF Senior IMF Resident Representative, Kenya

ONE OF the reasons most countries tax consumption of petroleum products is that it provides a sure source of revenue. In fact, petroleum products provide far more tax revenue than any other product, including tobacco or alcohol, especially in developing countries. In some countries, the revenue gains from consumption taxes on petroleum products have been as high as 3.5 percent of GDP and up to 30 percent of the total revenue. In some industrial countries, such as Italy and Norway, petroleum revenue has amounted to 2 percent of GDP.

The importance of petroleum taxation for most countries raises a number of interrelated questions. Can this heavy reliance on petroleum products for revenue be justified given the significance of petroleum in the

economy's production processes? Is there an optimum level of petroleum consumption taxes that a country should adopt? Are petroleum taxes consistent across countries? To answer some of these questions, the authors examined petroleum tax policies and their rationales in over 100 countries.

The findings are striking: there is a wide variation in retail prices and tax rates on different petroleum products across regions and within regions, as well as over time—a trend not found in any other product whose consumption is taxed and one that cannot be explained by economic theory alone.

Optimal taxation

Is there an optimal consumption tax rate for petroleum products? Unfortunately, economic theory does not provide much help. But theory

nevertheless tells us that petroleum taxes should be neither too high nor too low. High tax rates can create distortions in the production structure and hurt competitiveness by increasing the cost of an important intermediate input. Low tax rates that keep retail prices below world prices, or explicit subsidies, can distort the attractiveness of alternative production activities as resources get directed to areas where there is no comparative advantage.

How, then, do countries determine the level of taxation? The range of reasons that countries give for levying taxes on petroleum products provides some clues.

Why petroleum is taxed

Countries levy a tax on petroleum products for several reasons:

Table 1
Evolution of average retail prices ...
(US dollars per liter)

	Gasoline				Kerosene				Automotive diesel				Heavy fuel oil			
	1973	1974	1975	1976	1973	1974	1975	1976	1973	1974	1975	1976	1973	1974	1975	1976
Africa	0.21	0.29	0.71	0.66	0.14	0.18	0.41	0.40	0.15	0.21	0.49	0.51	0.04	0.05	0.29	0.29
Asia	0.15	0.27	0.38	0.52	0.06	0.13	0.25	0.29	0.07	0.11	0.28	0.33	0.03	0.07	0.16	0.22
Eastern Europe	...	...	0.42	0.46	...	...	...	...	...	...	0.34	0.35	...	...	...	...
Middle East	0.12	0.19	0.29	0.29	0.06	0.09	0.17	0.16	0.06	0.12	0.18	0.16	0.02	0.04	0.09	0.06
OECD ¹	0.22	0.30	0.71	0.71	0.11	0.15	0.35	0.37	0.17	0.22	0.49	0.49	0.03	0.08	0.15	0.14
Western Hemisphere	0.10	0.19	0.39	0.42	0.06	0.09	0.26	0.28	0.06	0.10	0.30	0.31	0.03	0.07	0.18	0.16
All countries	0.17	0.26	0.51	0.53	0.09	0.13	0.32	0.32	0.10	0.15	0.38	0.39	0.03	0.07	0.18	0.17

Sources: Katrine Saito, "An Examination of Changes in the Retail Price and Taxation at Petroleum Products (July 1973-July 1974)," *Studies in Domestic Finance* No. 9, The World Bank, September 1975; OECD, *Energy Prices and Taxes*, 1990 and 1991; *Energy* *Defence*, and staff estimates.
¹ The 1990 and 1991 data for regular gasoline pertain to unleaded regular.

Raise revenue. One of the main justifications in a number of countries, this consideration is bolstered by the administrative ease and the associated low cost with which petroleum taxes can be collected. Heavy reliance on petroleum taxation for revenue purposes, however, can be economically inefficient, to the extent that it raises the cost of an input that is essential to the production process. In some developing countries, high petroleum taxes could inhibit development of more remote regions, which, although entailing some economic cost, may be desirable on political and social grounds.

Charge for benefits and costs. Petroleum taxation is a way of charging for costs or negative external effects (externalities) that flow from petroleum consumption. It serves as a charge for the use of public roads, comparable

to the user charge governments levy on the provision of other services, such as mail delivery or electric power. Although difficult to measure, the tax can also be considered a charge for costs imposed by traffic congestion and environmental pollution. Reliance on fuel taxes as a means of charging for road congestion and pollution, however, may be inappropriate because the taxes affect congested/polluted and uncongested/unpolluted areas alike.

Redistribute income. A high tax is frequently levied on gasoline in developing countries partly because evidence indicates that gasoline is consumed mainly by the relatively high-income groups. In the same vein, it is argued that kerosene, a significant item in the consumption basket of the poorer segments of the population, should be taxed lightly or even

subsidized. The latter argument is sometimes supported by environmental considerations because, in many countries, kerosene and fuelwood are near substitutes.

Conserve foreign exchange. Net importers of petroleum products sometimes tax petroleum to restrain its consumption and to conserve foreign exchange. Major petroleum-importing countries may also impose taxes on petroleum products in an effort to constrain the ability of oil exporters to influence crude oil prices.

Close the wedge between world prices and the domestic cost of production. Because the marginal cost of producing gasoline is significantly lower than world market prices of gasoline in many petroleum-producing countries, domestic prices are frequently set well below world market lev-

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els. These countries justify this implicit subsidy on the ground that domestic consumers should benefit from low production costs. However, given that subsidies introduce inefficiencies in the production structure, it is generally more appropriate to redistribute the "rent" extracted through petroleum taxation to promote socially desirable objectives, although institutions and mechanisms for redistributive expenditure policy may be lacking in some countries.

A look at regions

The petroleum tax policies of 120 countries are examined for 1990 and 1991, and about half as many for 1973 and 1974. Given the variety of reasons for taxing petroleum products, it is not surprising that tax policies across countries are not consistent. Although the data used to describe and assess the petroleum tax policy of different countries may not be entirely consistent, the tables reveal certain facts and trends.

In response to the sharp increase in crude oil prices in late 1973 and early 1974, almost all regions sharply reduced the average tax

rate on all petroleum products; in contrast, the average tax rate on heavy fuel oil in Africa was increased modestly from a low initial level. This occurred mainly because most countries relied on specific duties that were left unadjusted in the wake of oil price increases. Indeed, between 1974 and 1991—when petroleum prices more than doubled—there was a large variation in changes in average tax rates on petroleum products in different regions. While average tax rates declined in Asia and the Middle East during this period, they increased in the member countries of the Organization for Economic Co-operation and Development (OECD) and in the Western Hemisphere. In 1991, regional average tax rates on all petroleum products were highest in the OECD countries and lowest in the Middle East.

A look at gasoline taxes in two country groupings, the OECD countries and Africa, revealed wide dispersions in rates, not only across regions but also within regions. The extraordinarily high tax rates on gasoline in some countries seem to be linked to the weight given to environmental and revenue consider-

ations. For instance, gasoline tax rates exceeding 200 percent in Denmark, France, Italy, Norway, Portugal, and Sweden appear to reflect the weight attached to containing pollution, whereas in The Gambia and Senegal, revenue considerations seem to be dominant.

Role of policy

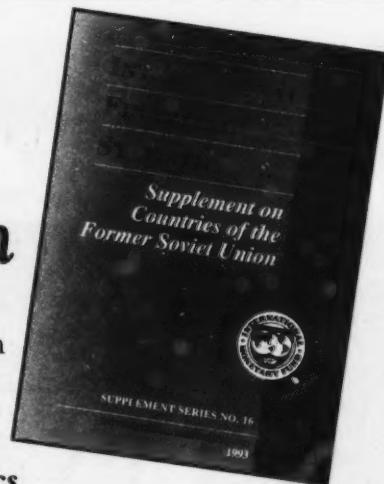
These findings also provide some perspective for guiding petroleum tax policy. As noted before, a relatively high tax rate on petroleum products can be distortionary, and a relatively low, or no, tax on selected petroleum products can be counterproductive because of possible adulteration with cheaper fuels and because of the perverse impact on resource allocation. Although it is reasonable to expect some diversity in petroleum tax rates among countries, depending upon the weight given to the various considerations noted above, a significant reduction in the present wide dispersion in petroleum prices and tax rates—across countries and products—appears warranted.

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IMF Balance of Payments Manual Adapts to a Changing World

MAHINDER S. GILL AND JACK BAME

Assistant Director

Consultant

Department of Statistics, IMF

THE PAST decade has seen important changes in the manner in which international transactions are conducted. These changes are, in particular, the result of the liberalization of financial markets, the growth in innovative financial instruments, and new approaches to the restructuring of external debt. In addition, there has been an unprecedented growth in the volume of international trade in services.

These developments provided the impetus for compiling the fifth edition of the IMF's *Balance of Payments Manual*, which was issued in September 1993. Like previous editions, the *Manual* provides guidance to member countries on how balance of payments and related data on the international investment position are compiled. The new features and changes aim at further integrating and harmonizing the balance of payments data with the IMF's statistical systems on money and banking and government finance and the revised 1993 *System of National Accounts (SNA)*. The goal is to enhance the potential of the balance of payments as a tool for economic analysis. The revised SNA was adopted by the UN Statistical Commission after a decade of work.

Unlike previous editions, the *Manual* provides for a framework of international accounts encompassing both (1) a conceptual framework for measuring and presenting the international transactions of an economy (e.g., transactions in goods, services, income, and financial instruments) and (2) the international investment position—a measure of the economy's stock of external assets and liabilities.

Other key changes introduced in the *Manual* include:

Redefining the current account. The *Manual* redefines the current account as encompassing transactions in goods, services, income, and the receipt or payment of current transfers. This definition excludes capital transfers, which are now included in an expanded and renamed capital and financial account. Further, transactions in the current

account for goods, services, income, and current transfers are identified separately. This change provides for greater harmonization and integration with the SNA and helps derive such national accounting aggregates as gross domestic product, gross national income, gross national disposable income, and national savings.

Disaggregating data on trade in services. Given the importance of detailed and disaggregated data on international trade in services for policy, the *Manual* has expanded the list of standard components and subcomponents in the classification of transactions in services. This emphasis stems from the perception that the production and trade of services differ from the production and trade of goods.

Renaming the capital account. The former capital account of previous editions of the *Manual* has been expanded and redesignated as the capital and financial account. The capital account covers all transactions that involve the receipt or payment of capital transfers and the acquisition or disposal of nonproduced, nonfinancial assets. The financial account, roughly equivalent to the former capital account, covers all transactions associated with changes of ownership in the foreign financial assets and liabilities of an economy and is structured on a hierarchical basis, that is, by functional category (direct investment, portfolio investment, other investment, and reserve assets), decomposition of assets and liabilities, instrument specification, domestic sector, and maturity breakdown.

Reorienting coverage of portfolio investment flows and stocks. The coverage of portfolio investment has been expanded and restructured to reflect the recent growth of new financial instruments. In addition to long-term debt and equity securities, money market debt instruments and tradable financial derivatives are explicitly identified in portfolio investment. Such instruments were treated as "other capital" in previous editions of the *Manual*.

Treatment of exceptional financing transactions. The *Manual* includes new and extensive coverage of various forms of exceptional financing transactions that have assumed increasing importance in IMF and member country operations in recent years. These transactions include (1) transfers, such as debt forgiveness, other intergovernmental grants, and grants received from IMF subsidy accounts; (2) direct or other equity investment, such as debt/equity swaps associated with debt-reduction operations; (3) general purpose borrowing (including bond issues) by the government or central bank (e.g., from foreign commercial banks); (4) borrowing (including bond issues) that is implemented by other sectors of the economy and encouraged by the government, usually with some form of exchange rate or interest subsidy; and (5) other transactions related to debt reorganization—such as the rescheduling of existing debt and the accumulation and repayment of arrears.

The international investment position. Reflecting the emphasis of the *Manual* on the articulation of a full set of international accounts, a consistent classification scheme is developed for income and financial flows and for accompanying stocks of external financial assets and liabilities. Because stock levels are often used to determine investment income receipts and payments in balance of payments accounts, such consistency is essential not only for the reconciliation of stocks and flows, but also for analyzing returns on external investments. In this regard, a new chapter on the international investment position is included, along with the factors that account for changes in the position over time. The principles and practices involved in valuation of international assets and liabilities are fully discussed, as are the effects of selected debt-related arrangements on the position. ■



Successful Rural Finance Institutions

JACOB YARON

BURDENED with low collection rates, heavily dependent on subsidies, and lacking innovative management, rural finance institutions (RFIs) as a group have not turned in a sparkling performance over the last decade. Yet a few successful RFIs have demonstrated that these institutions can be effective in providing creative financing to rural populations.

In order to receive credit for agricultural operations, low-income farmers in Thailand form small lending groups whose members are collectively liable for each farmer's loan. The group members typically live close together, know each other well, and decide among themselves who will be admitted. Borrowers

are effectively screened, and peer pressure keeps default rates low because the group's access to future loans is conditional on full and prompt repayment.

Joint liability and other nontraditional techniques have been adopted by four of the most prosperous Asian RFIs: the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the Grameen Bank in Bangladesh, and the Badan Kredit Kecamatan and the Bank Rakyat Indonesia Unit Desa in Indonesia. Like all RFIs, these four were originally established in developing countries to promote growth in low-income rural sectors by providing local farmers with affordable credit. While other RFIs have foundered, seemingly unable to meet their goals of servicing the rural poor, these institutions are well on their way to becoming self-sustaining, full-service "banks" for rural populations.

The key to their well-being lies in their innovative financial policies and delivery mechanisms, which respond to the very issues that have stymied other RFIs—dependence on subsidies, a low level of outreach, and lackadaisical administration. Recent World Bank research has developed new methods of measuring RFIs' success that help explain exactly how this has been done.

Why RFIs fail

The failures of most RFIs demonstrate why innovation is the key to the success of these institutions. Using traditional banking methods, RFIs in general have been unable to mobilize the voluntary savings necessary to offset their sizable loan portfolios. This has occurred in part because inadequate and depressed deposit interest rates—the result of easy access to cheap funds from state and international donors—have discouraged savings. Compounding this problem have been the administratively capped on-lending interest rates that are widespread in developing countries. These rates have not compensated RFIs for the risks and administrative costs of lending to small agricultural operations.

Faced with these dilemmas, RFIs have tended to favor large entrepreneurs, crowding out small farmers in an effort to minimize risk and transaction costs. The result has been institutions that are often little more than disbursement windows rather than balanced, full-service banks. Further, because RFIs are not under the same pressure as private banks, managers have not been motivated to introduce credit evaluation and follow-up procedures that would improve loan collection performance. Shoddy financial reporting prac-

tices make it almost impossible to determine when payments are overdue and what part of the loan portfolio is nonperforming or beyond recovery.

These are the primary issues the four Asian RFIs have addressed, and the World Bank's newly formulated measures indicate that these efforts have been highly successful.

Measuring performance

Given the widespread deficiencies and unique objectives of RFIs, finding adequate ways to measure performance has not been easy. Just as traditional banking methods have not served the RFIs well, traditional indicators, such as accounting profit, do not take into consideration the RFIs' goals or the subsidies required to keep the institutions afloat. The World Bank research proposes two primary criteria for judging the success of RFIs—level of outreach and degree of self-sustainability.

Outreach. The types of clients RFIs serve and the variety of financial services they offer determine the level of outreach. The four Asian RFIs serve the rural poor or low-income farmers, but with distinct definitional differences. For instance, Badan Kredit focuses on off-farm activities. Grameen Bank, on the other hand, hopes to improve overall economic conditions by financing all income-generating activities. It also provides nonfinancial services in the areas of education, health, and sanitation and supports other socially oriented programs. Unit Desa and the BAAC have directed their efforts toward low- to medium-income clients. Unit Desa has aimed at serving the rural population as a whole, while the BAAC has confined its lending to agricultural producers.

Other indicators of outreach help give a clearer picture of an RFI's success. They include the value and number of loans and savings accounts, the types of financial services offered, the number of branches and village posts established, the percentage of total rural population served, the annual growth of RFI assets over recent years (in real terms), and the participation of women. All of the thriving RFIs did well in at least two of these areas.

Growth is also often assessed as a component of outreach, but any measure of growth

The subsidy dependence index

Financial self-sustainability can be viewed as the inverse of subsidy dependence. A subsidy dependence index (SDI) is suggested for tracking the progress of an RFI in reducing its dependence on subsidies and for comparing the subsidy dependence of different RFIs providing similar services to a similar clientele. The SDI allows for a sensitivity analysis that estimates the percentage increase in the average, on-lending interest rate required to compensate for complete and immediate subsidy elimination. For example, an SDI of zero indicates that the RFI is fully self-sustainable; an SDI of 100 percent means that the average, on-lending rate used by the RFI must be doubled if operations are to continue without subsidies.

For simplicity, this interpretation assumes that an increase in the lending rate is the only change made to compensate for the loss of subsidies. However, the index does not imply that adjusting the interest rate is required or even feasible in all cases. The subsidy is measured against the interest the RFI earns on its annual average outstanding loan portfolio, since lending to a targeted clientele is the primary activity of a supply-led RFI.

Data indicate that the four RFIs under discussion here have differed substantially in their levels of subsidy dependence. Unit Desa was marginally dependent on subsidies in 1987 (a 3 percent SDI) and reached subsidy independence in 1989 with a remarkable SDI of -8 percent. The speed with which Unit Desa reached financial self-sustainability may be linked to its ability to build on existing infrastructure at the village level and its tremendous success in mobilizing voluntary savings. A similar strategy helped Badan Kredit avoid large start-up investments. Both the BAAC and Badan Kredit had moderate SDIs that improved over time.

In contrast, the figures for Grameen Bank indicate a high level of dependence on subsidies. With its 1987 SDI of 180 percent, Grameen Bank would have needed to increase its on-lending interest rate 178 percent (from 13.3 percent to 37.2 percent) to compensate for an immediate elimination of all subsidies. Grameen Bank made significant progress in reducing its SDI to 130 percent in 1989 but is still far from financial self-sustainability. It is unique among the four RFIs in providing nonfinancial services to its poor clientele. These activities clearly contribute to its relatively high level of subsidy dependence. In spite of its high SDI, Grameen Bank's overall financial performance has been significantly better than that of other formal credit institutions in Bangladesh, which tend to a generally wealthier clientele, do not provide additional services, and yet are burdened with huge loan defaults.

must take into account an RFI's stage of development. An established RFI may have a low growth rate, yet still be quite successful. In 1989, the newest of the four RFIs, Grameen Bank and Unit Desa, had real growth rates over three years of 34 percent annually. The more established RFIs, the BAAC and Badan Kredit, had significantly lower growth rates (around 15 percent and 4 percent, respectively, in 1989).

Self-sustainability. An RFI is said to be self-sustaining when its income equals or exceeds its expenditures, including imputed factors such as the opportunity costs of its equity. Traditionally, RFIs have been dependent on various types of implicit or explicit subsidies, including differences between market rates and rates paid on concessional borrowed funds, losses on foreign currency-

denominated loans absorbed by the state instead of the institution, obligatory deposits made by other financial or public institutions in the RFI at below-market rates, direct reimbursement of some or all operating costs, and exemptions from a reserve requirement or forced investments. The subsidy dependence index (SDI) measures the extent of an institution's reliance on such subsidies (see box).

Losing access to subsidies in the form of cheap funds often forces RFIs to increase their interest rates on loans or decrease their lending volume. This clearly would have happened to Grameen Bank, which relies on significant subsidies to support the free nonfinancial services it offers its members. On the other hand, the BAAC and Badan Kredit might have been less severely affected, while Unit Desa would not have suffered at all because it was clearly subsidy-independent.

Successful policies

The financial policies that played an important role in the success of the four Asian RFIs focused on savings, lending and deposit interest rates, loan repayment, and traditional loan security and collateral requirements.

Mobilizing savings. Although initially established as supply-led credit institutions that emphasized rural credit delivery rather than savings, all four RFIs have developed some savings services.

Voluntary savings mobilization has been a significant factor in Unit Desa's growth and ability to achieve self-sustainability. The financial ratio of the value of savings to the loan portfolio and the changes in this value over time are indicative of how well an institution is doing in substituting savings for state and donor funds. Unit Desa, which reported 110 percent savings in terms of its loan portfolio in 1989, has clearly been the most successful of the RFIs in backing its loan portfolio with voluntary savings; at 20 percent, Badan Kredit has been far less successful.

Interest rates. All four RFIs charged positive real interest rates ranging from 11 percent to 130 percent annually (the highest amount was charged on only a small number of Badan Kredit's short-term loans). Real rates have generally been above 20 percent annually for Badan Kredit and Unit Desa and below

10 percent for the BAAC and Grameen Bank. Although the rates were positive and in some cases relatively high, they were significantly lower than those in the informal money markets, the sole borrowing alternative for the RFI's clients.

This apparent willingness to support even high interest rates suggests that for poor rural borrowers, access to credit—not low interest rates—is the most important aspect of financing. In fact, the returns on the investments made with the borrowed funds were high enough to sustain most loan repayment schedules, as the high rates of loan collection demonstrate.

An RFI's ability to charge positive interest rates often hinges on the repeal of interest rate ceilings and the liberalization of financial markets. In the 1980s in Thailand and Bangladesh, respectively, the BAAC and Grameen Bank operated with legally imposed ceilings on loan interest rates. In Indonesia, however, Badan Kredit and Unit Desa were free to adjust their lending rates.

Loan collection. For RFIs, self-sustainability frequently depends on loan collection, since costly loan losses are the principal cause of insolvency, illiquidity, and increased reliance on state bailouts. The four RFIs discussed here reported high annual loan collection rates of 80–98.6 percent, and belated repayments significantly reduced potential losses. The RFIs used an array of incentives to instill financial discipline and build lender-borrower relationships. For example, both Badan Kredit and Grameen Bank, the RFIs targeting the lowest-income clientele, required borrowers to put aside at least 5 percent of the face value of the loan as obligatory savings. This exposure to financial services helped new customers accept financial discipline and reduced the lenders' credit risk.

Another method of promoting financial discipline involved interest rate rebates. The two Indonesian RFIs offered a monthly interest rebate of 0.5 percent (Unit Desa) and 1 percent (Badan Kredit) of the original loan value as an incentive for prompt repayment. Instead of providing a rebate, the BAAC imposed an annual penalty rate of 3 percent on arrears, or about one quarter of its nominal loan interest rate.

Collateral requirements. The four RFIs' solution to the loan security problem was a vital element in their overall success. Because strict collateral requirements usually put loans out of reach of low-income borrowers, three of the four institutions departed from traditional loan policies. Grameen Bank and Badan Kredit, which make small loans, offered credit without collateral. Badan Kredit now relies on character references exclusively

and Grameen Bank on the joint liability of borrowers.

The BAAC has also implemented joint liability for its small short-term loans, relying on the peer pressure inherent in small, homogeneous borrower groups. Unit Desa requires cosigners (usually the applicant's spouse), but borrowers are also required by law to provide collateral. Although it is often not cost-effective to collect collateral on bad loans, the threat of collection has probably acted as a deterrent, since defaulters attract unwanted attention if legal processes are instigated.

Delivery mechanisms that work

Delivery mechanisms have turned out to be just as important to the RFIs' success as financial policies. These mechanisms have been aimed at resolving the two most common problems RFIs face in developing countries: weak loan administration (screening borrowers, processing and monitoring loans, and



Jacob Yaron
*an Israeli, is Rural Finance
Advisor in the Bank's
Agriculture and Natural
Resources Department. He
was educated at the
Hebrew University in
Jerusalem.*

mobilizing and servicing voluntary savings efficiently) and ineffective loan collection procedures.

Loan administration. All four of the RFIs reviewed process loans efficiently, so that first-time borrowers typically receive their money within one or two weeks of submitting their applications. In part, this improved efficiency is due to incentive programs that tie RFI employee bonuses to quantifiable performance criteria. Badan Kredit, for instance, has distributed as much as 10 percent of a branch's profits to staff, and Unit Desa awards a yearly bonus of up to one month's salary for outstanding performance. Grameen Bank promotes staff members based on branch profitability and also distributes up to 10 percent of annual branch profits to employees. In addition, all four RFIs consider staff training crucial to success.

Another reason these RFIs are able to process loans quickly may lie in their incorporation of existing social structures, or peer groups, into the lending process. For example, because determining the creditworthiness of potential borrowers has been one of the princi-

pal problems facing RFIs, the two Indonesian institutions have relied on the social cohesiveness in rural Indonesia and the authority of the village leader to provide adequate information on loan applicants. A sound collection record enhances not only the status of the village head but also that of his community, increasing the chances that more members will be able to borrow in the future. The penalty for poor repayment is strict: additional future borrowing is prohibited.

Lending to small groups formed by potential borrowers who are collectively responsible for repayment serves several purposes. Small groups (Grameen Bank prefers 5 members, although the BAAC permits up to 30) that are both socially and economically homogeneous generate a sense of belonging and a clear perception that each individual's performance is crucial to the group's overall success or failure. Motivated group members tend to monitor their more lax peers, for no group member can receive further credit until the entire group's debts are repaid. These groups therefore eliminate or drastically reduce the "free rider" problem.

The BAAC and Grameen Bank have relied heavily on this type of self-help group to promote and deliver loans and to provide a link with individual borrowers. Grameen Bank's groups hold routine meetings that allow members to review loan applications. The open, face-to-face dialogue used in these meetings encourages and builds accountability. In addition, the meetings touch on social, educational, and health-related issues, generating a stronger sense of solidarity that reinforces pressure on members not to default.

The RFIs have also utilized components of "mobile banking" as an innovative means of providing low-cost saving and lending services to very poor clients. Badan Kredit staff visit a different village each day of the week (often market day), collecting deposits and weekly loan repayments and greatly reducing transaction costs for both client and bank. The BAAC offers assistance in filling out loan applications at the village level, although disbursements and repayments are handled at central branch locations.

Loan collection. To encourage borrowers to pay back their loans on time, the four RFIs reward borrowers who adhere to payment schedules with moderate increases in credit eligibility. In addition, repayment is tailored to clients' needs. The two Indonesian institutions offer flexible payment schedules that borrowers can adjust according to cash-flow patterns. Badan Kredit's standard 3-month loan repayment plan makes calculating the 12 weekly payments easy, even for inexperienced or illiterate clients, and

contributes to customer confidence.

In contrast, the BAAC and Grameen Bank use a rigid loan repayment structure, which nevertheless has been instrumental in maintaining financial discipline. Grameen Bank introduces inexperienced borrowers to the financial system by requiring them to make regular weekly loan payments for a year. This system suits the cash flow of the various non-primary agricultural operations Grameen Bank targets and has cut both administrative costs and loan losses. Reflecting the agricultural crop cycle, the BAAC requires borrowers to repay short-term loans 11 months after disbursement in a balloon payment. Interestingly, borrowers facing repayment difficulties have preferred to incur the high financial costs of borrowing from moneylenders rather than jeopardize their borrowing eligibility with the BAAC.

External influences

The environment in which the Asian RFI's discussed here operate has also contributed to their success. All four institutions reviewed have enjoyed stable economic conditions in countries with annual inflation rates of less than 10 percent. This stability has contributed to reduced uncertainty, higher returns on investment, and impressive repayment rates. In contrast, an unstable economy characterized by erratic changes in relative prices and unpredictable austerity programs can abruptly curtail disposable income and adversely affect return on investments. A volatile inflation rate that raises the costs of adjusting repayments and reduces the value

of savings can also render lending on a small scale impractical.

Where are RFIs headed?

Programs that have been adequate in a region with one set of social values may not offer the right approach for providing credit services to the rural poor in a different socioeconomic environment. Based on the experiences of the four RFI's presented in this study, it is clear that several critical issues must be addressed in replicating their approaches, techniques, and procedures.

- A social mechanism tailored to the client base can lower transaction costs and effectively use peer pressure for screening loan applicants and collecting loans. Reviewing both the performance record of similar programs in the region and the targeted clientele's perception of the moral obligation associated with loan collection helps define the most useful mechanism.

- Variables such as population density and infrastructure may offer special limitations or opportunities for replication of a specific approach, such as mobile banking. Replication will also depend on the economic and political conditions in a certain country or region, since previous credit experience, lending regulations, and adverse economic conditions can seriously hamper a program's success.

- Eliminating or gradually reducing subsidies helps RFI's gain long-term financial viability. Various methods of reducing subsidy dependence are available, such as applying positive on-lending interest rates that are high enough to cover financing and administrative

costs while maintaining the value of the RFI's equity in real terms. Deposit interest rates can be increased in order to mobilize voluntary savings, which gradually substitute for the donor funds that have financed the loan portfolio. Finally, improving loan collection and reducing operating costs will help keep administrative overhead costs low.

However, state or donor support in the form of increased financial resources (not necessarily at subsidized interest rates) during the initial phase of an RFI's operations can contribute to the institution's success. Temporary lending from the state or donor may help close the funding gap between an RFI's savings mobilization and its outstanding loan portfolio. Because savings mobilization can be the driving force behind an RFI's growth, availability of funds, not their cost, is the primary issue. This finding strongly suggests a reduced role for subsidies.

Finally, state and donor support should concentrate on institution building. The lack of emphasis on institution building in RFI's is a common characteristic of ailing supply-led credit institutions: too few resources are devoted to training, mobilizing savings, or creating management information systems and incentive systems for clients and staff. All of these elements are essential to an RFI's transformation into a well-balanced, self-sustainable, independent financial institution.

For further information, see "Successful Rural Finance Institutions," by the author, *World Bank Discussion Paper 150*, January 1992.



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Informal Savings Collectors in Ghana: Can They Intermediate?

WILLIAM F. STEEL AND ERNEST ARYEETEEY

Advisor
Africa Technical Department
The World Bank

Consultant, The World Bank
Senior Research Fellow,
University of Ghana

IN THE marketplaces of West Africa, individual "mobile bankers" help traders and others accumulate savings through small daily deposits. As institutions emerge that link these savings collectors to the formal financial system or adopt their methods, intermediation between small informal savers and borrowers is expected to increase.

A market woman in Ghana typically sees her "banker" every day to deposit as little as 25 cents. At the end of the month, she gets back her accumulated savings, with which she replenishes her stock or buys something that she could not afford out of one day's profits. She often requests an advance on the month's expected proceeds, but her banker may avoid lending because he lacks cash reserves or access to credit in case repayment is delayed.

This banker is an informal savings collector, known in Ghana as a *susu* collector. In Accra, over 500 of them have formed the Greater Accra *Susu* Collectors Cooperative Society (GASCCS). They play an important role in mobilizing savings in West Africa through their daily collection of deposits. They differ from community banks and

group-based organizations, such as Grameen Bank (see "Successful Rural Finance Institutions" in this issue), in that they are individual entrepreneurs who perform a financial service without any capital of their own. Evidence from surveys of three marketplaces in Ghana suggests that they could intermediate more fully—use the funds they obtain from savers to lend to borrowers—if they had access to temporary liquidity.

How informal collectors work

Savings collectors contract with clients to collect a fixed amount daily (or at regular intervals), typically ranging from \$0.25 to \$2.50. In Ghana, this amount averages \$0.73 a day for each client. At the end of each month, the savings are returned to the depositors; the collectors keep one day's deposit, or 3.3 percent of the monthly savings, as commission.

Why do people pay to save? First, the *susu* system functions as a financial management service. Depositors commonly use the accumulated funds as working capital to restock the supplies that enable them to earn a stream of profits. Second, by pledging to set aside savings for their *susu* collector, market women can protect their savings from the incessant appeals of family and friends. Third, in countries where commercial banks are ill-equipped to accept small deposits by often illiterate savers, depositors willingly pay for the convenience of banking at their workplace daily.

Collectors put the bulk of their daily receipts into commercial bank accounts, retaining some to return to clients who need funds before the end of the month and some for their own short-term business transac-

tions. In one branch, such deposits reached 40 percent of total demand deposits. Nonetheless, bank managers, largely unaware of the collection activities of account holders, have done little to facilitate deposits by *susu* collectors.

Collectors end up with net earnings of nearly \$200 a month, or six times Ghana's average per capita income, with about 11 percent of their gross fees going to expenses. Although collectors earn a satisfactory livelihood, they would like to increase their earnings by making more advances to attract more clients or by lending to nonclients (with a typical fee of 20 percent on a three-month loan).

Other informal mechanisms

Informal savings systems have a long history in the developing world, including group forms that involve several individuals pooling their resources. Some of these systems are described below.

ROSCAs. Rotating savings and credit associations (ROSCAs) are found throughout the world. Typically, all members contribute a certain amount to a common pool at regular intervals; each member receives the pool in turn. All members except the last receive the pooled amount sooner than they could accumulate it individually.

Despite their apparent simplicity, ROSCAs can be problematic to administer, for example, when it comes to determining the order of recipients. ROSCAs also carry the risk that members who receive the pool early will not continue to contribute. Moreover, ROSCAs are not integrated with the financial system as a whole, and intermediation is confined within

a fixed group: those who get the pool early and those who get it later.

Moneylenders and trade credit. Moneylenders, a common source of informal credit throughout the developing world, rarely serve as financial intermediaries. They often lend surplus funds from their own business activities, especially trading. Merchants may also provide credit to increase their sales; if the credit is in the form of cash, it is considered moneylending, if in kind, it is trade credit.

Where moneylenders are few or operate illegally, they are an unreliable and often expensive source of finance for business investment and working capital. In Ghana, moneylenders have historically charged a fee of 100 percent on loans of 9–12 months. Long-term rates to established clients have recently fallen to about 50 percent a year as trade liberalization has increased surplus funds in the hands of traders serving as moneylenders.

Moneykeepers. Savers may entrust their funds to a moneykeeper—a responsible person who holds the money until it is needed. Individuals may also form a group that functions in the same way as a moneykeeper. Its members save toward a common event (annual festival) or community development objective, sometimes making loans to earn interest. But moneykeepers neither engage in intermediation, although they sometimes make use of the funds, nor seek deposits, as *susu* collectors do.

Lending potential

Banks are unlikely to meet the credit demands of the self-employed and family ("micro") enterprises. For a commercial bank to undertake such lending, it would have to hire agents at a cost of about 7.5 percent of the monthly loan amount (calculated on the basis of collectors' labor time and average earnings)—high relative to commercial bank spreads.

Ghana's *susu* collectors are well placed to take on the role of intermediary that is lacking in the informal financial system. They would like to expand lending but fear that slow repayment would leave them short of the funds they need to return their clients' savings at the end of the month. Although 60 percent of their clients typically request advances, the collectors surveyed could respond to only 13 percent in any given month, often with smaller amounts than requested. They believe that many more of their clients represent good risks: currently, fewer than 10 percent of borrowers are delinquent at the end of a one-month loan, and loans are rarely overdue by more than one month. Through daily visits, savings collectors can closely monitor repayment perfor-

mance on any loan. Obtaining information about additional borrowers and collecting more loan repayments daily would entail little marginal cost.

If the intermediating potential of savings collectors is realized, small credits available to traders and microenterprises would increase substantially. Savings collectors are already linked to the formal financial sector through their bank accounts. If this link could be completed to give them access to the short-term credit they need to cover end-of-month shortfalls, they could expand lending without risking a liquidity crisis. The higher probability of credit would, in turn, raise the number of depositors. The risk of default by new depositors, who would be saving mainly to obtain credit, could be controlled by requiring them to save for at least six months before applying for credit.

Emerging links

Commercial banks, historically oriented toward large firms, have been understandably reluctant to extend unsecured lines of credit to individual customers with accounts as volatile as those of savings collectors. And, if liquidity is tight and interest rates on government-backed bonds are high, commercial banks have little incentive to adapt their methods to small, informal clients.

For savings collectors to gain access to bank credit, they will have to be linked indirectly to commercial banks. One possibility in Ghana is for the GASCCS to seek a bank line of credit backed by treasury bills—the form in which it holds the assets of its social welfare fund. It could then provide credit to its members, who would be able to expand lending without fear of falling short of cash. Alternatively, the GASCCS could establish a credit union that could intermediate members' funds and gain access to a commercial bank. But these approaches would transform the GASCCS into a financial institution, requiring it to develop institutional banking or on-lending procedures. Other developments may be more promising.

Ghana's financial liberalization since the mid-1980s has fostered institutions that build on the successful methods of savings collectors and may eventually facilitate their role as intermediators. In the late 1980s, *susu* companies employed collectors and attracted depositors by guaranteeing loans to those who accumulated savings for six months or more. The rapid growth of deposits reflected the high demand for credit among the clients of *susu* collectors. Operating essentially as independent savings and loan associations, these companies offered true financial intermediation. But poor management and automatic

loan extension without any screening of borrowers caused most of them to fail by 1991.

Partly in response to the collapse of *susu* companies, the Bank of Ghana issued regulations governing the entry and operation of financial institutions other than banks. As of 1993, only the NGO Women's World Banking Ghana had succeeded in registering a *susu*-type operation; it provides interest on deposits over six months and extends loans selectively.

Purchase-finance companies, based on the *susu* method, have had some success since 1985. They provide partial credit to purchasers of consumer durables and equipment, with the goods serving as collateral. New clients may have to save up to half the purchase price before obtaining a loan, typically to be repaid over three to six months. These companies intermediate between informal savers and borrowers without direct links to formal banks. Although they serve a market niche of somewhat larger enterprises than the usual clients of *susu* collectors, most of them are not large enough to meet the requirements of the Bank of Ghana to operate as a registered financial institution.

In 1993, a new private savings and loan institution targeted the informal market niche by locating in a marketplace and offering convenient services to larger traders and to *susu* collectors. Registered with the Bank of Ghana and affiliated with a commercial bank, this institution links the informal and formal financial systems. Once it gains enough confidence in its savings collector clients to extend credit to them, the collectors will be able to extend credit to their own clients.

The introduction of private banking techniques oriented toward traders and savings collectors is facilitating greater intermediation by savings collectors and indirectly linking them to the formal financial system. Other informal financial institutions are also using *susu* collectors' methods to intermediate between small-scale savers and borrowers. These dynamic developments in informal finance are improving the ability of the financial system as a whole to mobilize savings and intermediate funds. ■

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Promoting the Development of Indigenous People in Latin America

SHELTON DAVIS AND WILLIAM PARTRIDGE

INDIGENOUS people—estimated at more than 300 million worldwide—inhabit over 70 countries, covering almost every climatic zone. Once ignored, they are now seen as key players, especially in Latin America, in rural development programs and in management of fragile ecosystems.

"Indians"—the name Columbus mistakenly gave to the diverse assemblage of peoples and cultures that inhabited the Western Hemisphere before the arrival of Europeans—have always been among the most disadvantaged segment of the Latin American rural population. The majority of these people are the descendants of the great Aztec, Maya, and Inca civilizations and still speak native languages. Today, they comprise large parts of the rural peasant and urban migrant populations of Mexico, Central

America, and the Andean countries. In the Amazon Basin region, there are also scores of relatively isolated tribal societies, many of which have only recently come into sustained contact with outsiders as a result of new road building and land settlement programs.

While definitions vary from one country to the next, and most census data are of questionable reliability, recent demographic studies estimate that there are approximately 34 million indigenous people in Latin America and the Caribbean, or 8 percent of the region's population. Within certain countries, however, their number relative to the national population is much greater, especially in rural areas where most indigenous people live. Although many are bilingual in Spanish and their native languages, multilingualism (over 400 aboriginal or native languages are still spoken in the region) remains a dominant characteristic of much of the cultural landscape.

In Mexico, persons who speak one of the 56 indigenous languages make up over 14 percent of the national population and number over 12 million. In Guatemala, there are about 4 million indigenous people, speaking 22 distinct Mayan languages and comprising 43.8 percent of the national population. In Bolivia, the country with the highest proportion of indigenous inhabitants—56.8 percent—there are 4.1 million indigenous people. Peru has 9.1 million indigenous inhabitants (40.8 percent of the national population), and Ecuador has 3.1 million (29.5 percent).

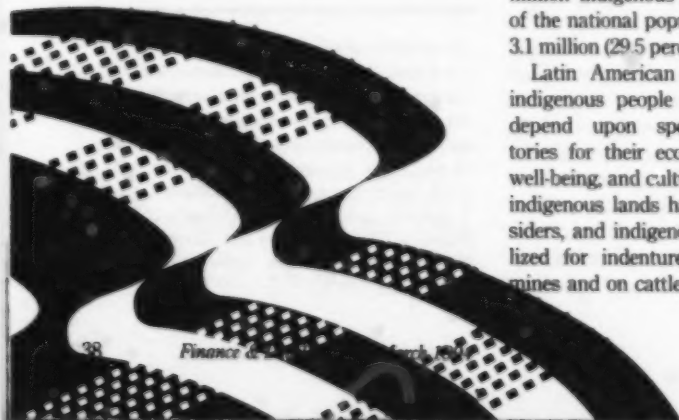
Latin American indigenous people—like indigenous people throughout the world—depend upon specific lands and territories for their economic livelihoods, social well-being, and cultural survival. Historically, indigenous lands have been coveted by outsiders, and indigenous labor has been mobilized for indentured or low-paid work in mines and on cattle ranches and plantations.

Missionaries have played an important role in cushioning the negative effects of Western contact (disease, forced dislocation, etc.), but their programs have been introduced at the price of generating dependency and a loss of indigenous religions, values, and cultural pride.

Since the end of World War II, Latin American governments—in the names of economic development and increased social integration—have taken the lead in directing the processes of cultural change among indigenous communities. Typically, they have done so through stemming labor abuses, agrarian reform legislation, and the design of various educational, public health, job-training, and rural development programs. Most of these government programs have been centrally planned and highly paternalistic; very few of them have built upon the cultural strengths of the indigenous populations or entail their active participation.

Although there are isolated examples of success with bilingual education and improvements in public health, most studies indicate that government-sponsored rural development efforts have not significantly affected the overall welfare or opportunities of Latin America's indigenous population. To the contrary, recent studies carried out by the World Bank and other development agencies indicate that Indians remain the poorest and most destitute of the region's population, with the highest rates of infant mortality and childhood malnutrition and the lowest rates of literacy and schooling (see "Indigenous People and Poverty in Latin America" in this issue).

Recently, a new vision has emerged in Latin America that challenges conventional, top-down approaches to the (misnamed and misconceived) Latin American "Indian problem." It builds on the positive qualities of indigenous cultures and societies, including a strong





sense of ethnic identity, close attachments to specific landscapes and territories, a sophisticated knowledge of natural resources and the environment, and the capacity to collectively mobilize labor, capital, and other resources. Currently, several programs are under way that promote the idea of a new partnership among international agencies, governments, and nongovernmental organizations for purposes of promoting indigenous development, but much remains to be done.

The new vision

A large part of the impetus behind the new thinking comes from indigenous people themselves. The past two decades have witnessed a cultural renaissance among these people and the growth of a vast network of grass roots Indian organizations. Ironically, some of the same forces that have traditionally undermined Indian cultures and identities—such as missionary influences, schooling, and increased urban migration—have enabled this renaissance. In fact, in almost all countries where there are significant indigenous populations, younger and more educated Indians are reaffirming (and sometimes rediscovering) their indigenous cultural roots and identities, using them to form new ethnic organizations and federations (see box).

In general, the platforms of the new indigenous organizations are based upon combating negative attitudes toward indigenous people, participating in local decisionmaking and development policies, asserting indigenous languages and cultures, and, most important, maintaining some control over indigenous lands and natural resources. Increasingly, they are also seeking to ensure that indigenous people receive a larger share of national development budgets while asking international agencies to provide support and technical assistance for the groups' development projects.

Role of international donors

Over the past year, several international agencies, including the World Bank, have been meeting regularly to explore ways in

An indigenous federation in the Ecuadoran rain forest

One of the oldest and most successful of the indigenous organizations is the Shuar Federation in the tropical forests of eastern Ecuador. It was formed in the 1960s, under the impetus of Catholic missionaries, to provide the Shuar, who live in scattered hamlets, with some type of collective legal protection from colonists who were invading their traditional territory. Forming into nucleated residential groups called *centros* and then into larger subregional associations, the federation successfully petitioned the government for collective land titles.

In the early 1970s, the federation also established a bilingual radio school program, which essentially transformed the nature of schooling and education in the rain forest. Before the program was established, fewer than half of school-age Shuar children completed primary school. Not only was it difficult for children to attend schools because of the long distances from their homes and the difficulties of travel, especially in the rainy season, but dropout rates were extremely high because the curriculum did not take into account the children's native language and culture. Over the course of a decade, the federation-managed radio school program proved to be a great success, and the number of schools connected into the radio network and staffed by federation-trained teachers increased from 30 to 177. In the 1990s, the government officially recognized the program and used it as a model for other bilingual and bicultural school programs in the eastern part of the country.

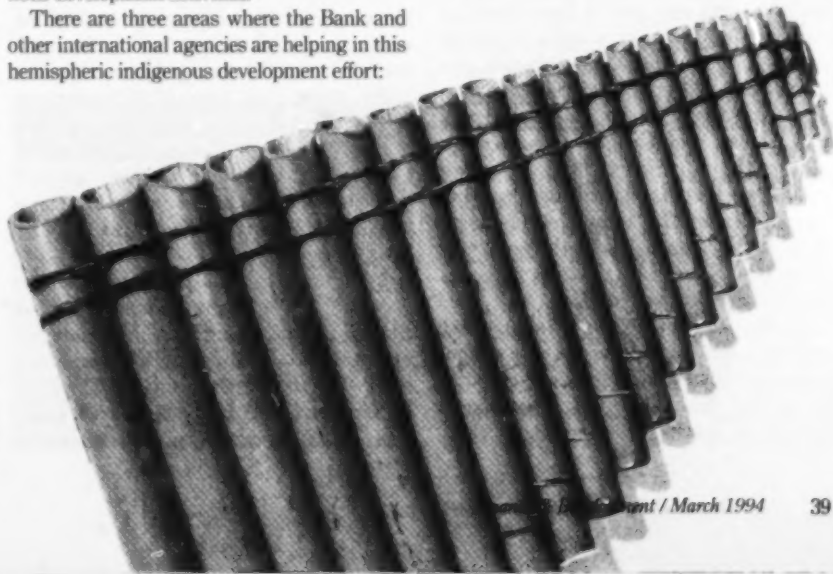
Land regularization and natural resource management. Although the situation varies not only among countries but also among geographic regions (e.g., between the highlands and the lowlands), most indigenous communities must contend with threats from outsiders interested in their lands, forests, waters, and other natural resources—yet they often lack clear land ownership rights or their statutory rights are not in fact protected. One way the new indigenous organizations are trying to respond to these threats is by calling for greater government recognition and protection of their lands and natural resources.

As far back as 1982, the Bank issued a policy that stated that it would "not assist development projects that knowingly involve encroachment on traditional territories being used or occupied by tribal people, unless adequate safeguards are provided." As a result, the Bank has assisted several Latin American governments (e.g., Bolivia, Brazil,

Paraguay, and Peru) in designing and financing programs for the identification, demarcation, and registration of indigenous lands, especially in the rain forest regions of lowland South America. In the Brazilian Amazon alone, the government has identified and demarcated some 5.4 million hectares of indigenous land under Bank-funded projects.

which they might more systematically assist these new indigenous development programs. They are also working closely with the La Paz-based, Latin American Indigenous People's Fund (Fondo Indigena), which was established by a number of Latin American governments in July 1992 to provide technical assistance and channel resources to indigenous development activities.

There are three areas where the Bank and other international agencies are helping in this hemispheric indigenous development effort:





Based upon these and other experiences, the Bank revised its policy in 1991, placing more emphasis on the informed participation of indigenous people in the development process—including the design, implementation, and monitoring of their own development programs.

How have these projects fared? A review recently conducted by the Bank shows they have been most successful when accompanied by research, technical assistance, and training programs that combine indigenous people's environmental knowledge (which is often quite sophisticated, especially in the lowland forest regions) with modern forms of natural resource management. Thus, a number of recent Bank projects—such as the Pilot Program to Conserve the Brazilian Rain Forest and the recently approved Colombia Natural Resource Management Project—contain both indigenous land regularization and natural resource management programs. These projects, which are much more participatory than earlier ones, provide new models of how to improve the management of natural resources vital to the economic survival and environmental sustainability of indigenous and other forest-dwelling rural communities.

Technical assistance and training programs. Another major need is for greater technical assistance and training—ranging from simple accounting and microenterprise development to the use of new technologies, such as computers or satellite imagery, for land demarcation and natural resource planning. Experience indicates that these programs are most effective when they are conducted in the native languages, reach out to indigenous women, and incorporate indigenous knowledge and technologies.

The Bank is currently working with the Fondo Indígena and several Latin American governments to support a series of special training and institutional strengthening programs. These programs will be aimed primarily at enhancing the ability of the indigenous organizations to design their own development strategies and formulate their own development projects. The first of these training programs will be held in Chile (involving the Mapuche, Aymara, Atacameño, and Rapañui peoples), followed by similar programs in Bolivia, Guatemala, and Mexico.

Access to credit and investment capital. Latin American indigenous organizations and some governments also are looking to the Bank and other international agencies to provide them with new chan-



Shelton Davis
a US national, is Principal Sociologist in the Social Policy and Resettlement Division of the Bank's Environment Department. He has a PhD in Social Anthropology from Harvard University.



William Partridge
a US citizen, is Principal Anthropologist in the Bank's Technical Department for Latin America and the Caribbean. He has a PhD in Social Anthropology from the University of Florida.

nels of credit and investment capital. Unfortunately, in many countries, indigenous people do not have access to traditional forms of finance because of their poverty and lack of collateral for loan guarantees. Furthermore, even when sources of finance are available, the people often lack the training and experience in law, economics, accounting, and administration necessary to tap these sources successfully and manage their own development agendas.

To overcome these problems, several experiments in opening up new channels of credit and investment capital are now being tried. For example, the Mexican Government, as part of its national antipoverty program, has created a series of "regional solidarity funds" to provide credit to indigenous landholding groups, small coffee-grower and fishing cooperatives, artisan groups, rural women's associations, and various types of microenterprise projects. Each solidarity fund—there are now over 100 nationwide—has its own indigenous management council and provides long-term and low-interest credit to member organizations for on-lending to member communities and associates.

Although it is still too early to evaluate the overall results, early indications show a strong demand for the program among indigenous groups. In the heavily populated indigenous state of Oaxaca, for example, Mexico's National Indigenous Institute (INI) has established 22 funds representing 445 rural organi-

zations and 1,466 indigenous communities. Between 1990, when the program was initiated, and 1992, it transferred 34,725 million Mexican pesos (about \$13.35 million) to the Oaxaca funds for over 950 productive projects. Loan recuperation rates are not as high as organizers had expected, but INI has been restructuring the program to make it more compatible with the needs, skills, and repayment capacities of participants. It is also seeking legal changes that would enable the funds to become permanent rural finance institutions under the full control of the indigenous management councils. As part of a \$350 million decentralization and regional development loan, the Bank is providing INI with technical assistance funds to improve the management of the program and to conduct an evaluation study.

Poverty alleviation

Some years ago, the well-known development economist Albert O. Hirschman published *Getting Ahead Collectively* (Pergamon Press, 1984), a book on grass roots development experiences in Latin America. One of the themes was that, as these countries move toward civilian rule and democracy, there is renewed space to release the "social energy" of various local organizations dedicated to more popular and participatory forms of development. Although Hirschman alluded only briefly to grass roots indigenous organizations, they are perhaps one of the clearest reflections of this new phenomenon. Moreover, in Latin America, these new indigenous organizations bring an added dimension to the grass roots development equation—the continuing existence of indigenous languages and cultures that go back thousands of years, before the arrival of Europeans. They also serve as the basis for socially mobilizing indigenous people for the twin goals of cultural reaffirmation and rural poverty alleviation. ■

For more details, see "The Fate of Indigenous Peoples: Consultation and Coordination Can Avoid Conflict," by William Partridge, in *The Environmental Forum*, Vol. 7, No. 2, 1990; "Protecting Amerindian Lands: A Review of World Bank Experience with Indigenous Land Regularization Programs in Lowland South America," by Alaka Wali and Shelton H. Davis, *Latin America and Caribbean Region Technical Department, Regional Studies Program Report*, No. 19, 1992; and "Indigenous Views of Land and the Environment," edited by Shelton Davis, *World Bank Discussion Paper No. 188*, 1993.

Indigenous People and Poverty in Latin America

GEORGE PSACHAROPOULOS AND HARRY A. PATRINOS

INDIGENOUS people in Latin America live in conditions of extreme poverty, but a recent World Bank study shows that by targeting human capital—especially education—policymakers can help raise incomes, which, in turn, would help reduce poverty.

At a time when there is growing international interest in bringing indigenous people more into the development process, there is also a realization that apart from casual observation, little is known about their socioeconomic condition. Extensive research by anthropologists documents that indigenous people are among the poorest of the poor. But so far, economists have ignored this problem because of a lack of quality micro-data that include information on the ethnic origins of individuals. What has been missing are the economic studies—other than a few country studies—that investigate the depth and pervasiveness of the poverty and the reasons behind it.

In an effort to answer these questions, especially on a regional level, and to complement the rich body of anthropological research at hand, the World Bank recently tried to document the socioeconomic situation of the estimated 34 million indigenous people in Latin America (8 percent of the region's population) using economic methods. The results confirm that indigenous people are a seriously disadvantaged group—in areas such as education,

even worse than believed. But the results also show that policymakers can help them improve their plight by strengthening human capital.

The study looked at four countries (Bolivia, Guatemala, Mexico, and Peru), which together have 81 percent of the continent's indigenous population. The data were drawn primarily from national household surveys, which were carried out in 1989—with the exception of Peru, for which there was a 1991 Living Standards Survey (carried out with World Bank support). Data for Bolivia and Peru were biased toward urban populations.

Although definitions of indigenous people differ from country to country due to the use of various survey instruments, the study relied on three variables to identify the indigenous and nonindigenous populations: language spoken, self-perception, and geographic concentration. For Bolivia and Peru, language was the defining characteristic. In Bolivia, it was possible to distinguish between monolingual and bilingual (Spanish and indigenous language) individuals, while in Peru, only monolingual indigenous or

Spanish speakers could be isolated. For Guatemala, self-identification or self-perception was the key, whereas in Mexico, language and geographic concentration were used.

How poor is poor?

Although the situation has improved somewhat in recent decades, there is no question that the indigenous people of Latin America live in conditions of extreme poverty, with the children unable to keep up with their non-indigenous counterparts.

Income levels. While a large proportion of the total population of Latin America is poor (earning less than \$2 a day), the overwhelming majority of indigenous people are poor. In Guatemala, for example, although 66 percent of the population is poor, 87 percent of all indigenous households are below the poverty line. Indeed, in all the countries studied, indigenous people have much lower incomes than their nonindigenous counterparts (see table).

Living conditions. Compared with the nonindigenous population, the living conditions of indigenous people—as measured by housing conditions and access to public services—are generally abysmal.

Although home ownership is higher in more indigenous areas, a closer examination reveals a clear disparity in the physical composition of homes. In Mexico, homes in less indigenous areas are built from higher-quality materials, such as concrete and brick. In Bolivia, households headed by a nonindigenous person have more rooms per capita.

As for access to public services, in Guatemala, less than one third of all indigenous households have water piped to their homes for their exclusive use, compared with almost half of nonindigenous households, and approximately one half of all indigenous

Being indigenous means being poor		
(percent of population below poverty line) ¹		
	Indigenous	Nonindigenous
Bolivia	64.3	40.1
Guatemala	86.6	53.9
Mexico	80.6	17.9
Peru	79.0	49.7

Source: "Indigenous People and Poverty in Latin America: An Empirical Analysis."
¹ An individual is considered to be below the poverty line if his/her income is less than \$2 per day.

households have no sanitary services and three fourths have no electricity. In Peru, only 46 percent of indigenous people's homes have public water facilities, while 31 percent use wells and 15 percent use the river as a source of water; only 21 percent of indigenous homes have public waste disposal.

An examination of rural/urban differences further highlights the indigenous population's deprivation. As indigenous households are less likely to have a public source of water in both rural and urban areas, indigenous people are much more likely to obtain water from wells; 16 percent of urban indigenous households and 39 percent of rural indigenous households have wells, whereas the corresponding proportions of Spanish-speaking households are only 2 percent and 10 percent. While the proportion of rural nonindigenous households that use rivers as their water source is larger than in rural indigenous households, the rural prevalence of indigenous people results in a greater proportion of the indigenous population being exposed to the diseases associated with poor water quality.

In terms of fuels used, almost half of all indigenous households rely on kerosene as a source of light, whereas 88 percent of the homes of Spanish speakers use electricity. Within urban areas, the use of kerosene is seven times greater in indigenous homes than in the homes of Spanish speakers.

Health. Indigenous people are more likely to become ill than nonindigenous people, but they are much less likely to consult a physician or receive needed vaccinations. Although the average cost of both hospitalization and medicine is less for indigenous people, only 57 percent of them buy medicine, compared with 81 percent of their nonindigenous counter-



parts. In Bolivia, there is a higher tendency among indigenous people for a disability to be sufficiently severe to keep them out of work for more than a week.

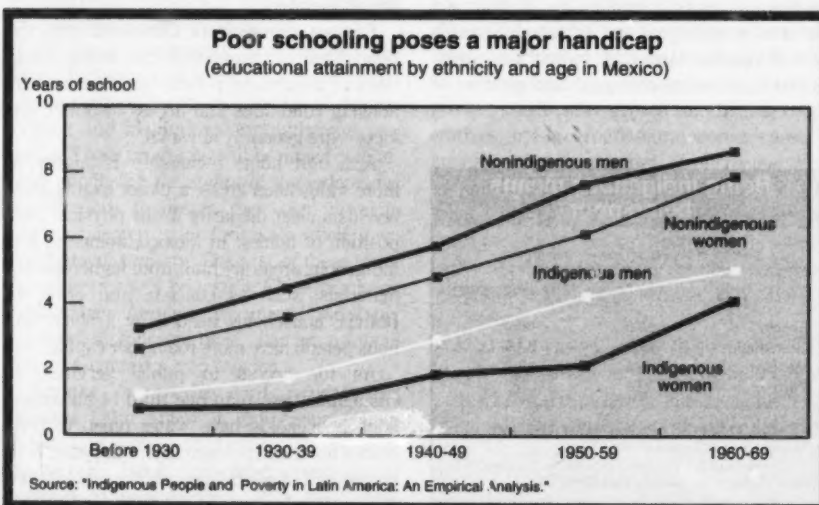
Schooling. Access to formal education has expanded in recent years and improvements have occurred in indigenous areas, but indigenous people rank far lower than their non-

indigenous counterparts in this critical area of human capital formation. Not surprisingly, the parents' low educational attainment is reflected in the schooling of their children, with indigenous children more likely to repeat grades at the primary level and more likely to drop out of school altogether. School attendance is also affected by child labor, both in the home and in the labor market; as hours worked by the child increase, school attendance decreases.

- In Bolivia, schooling levels are approximately three years less, on average, than for nonindigenous individuals; the difference is even greater for indigenous females, suggesting that they are the most disadvantaged segment in Bolivian society.

- In Guatemala, the majority of indigenous people have no formal education and of those who do, the majority have only primary education; indigenous people have only 1.3 years of schooling on average and only 40 percent are literate.

- In Peru, nonindigenous adults have 20 percent more education than their indigenous counterparts, of whom only 40 percent of heads of household continue beyond primary school and only 6 percent receive some post-secondary education. In contrast, 62 percent of Spanish-speaking heads of household have



some secondary schooling and 22 percent have some postsecondary education. Enrollment for nonindigenous children (40 percent) is higher than for indigenous children (36 percent), and school attendance is greater among urban children.

• In Mexico, where educational gains have been particularly strong in recent decades, vast inequities still exist between the indigenous and nonindigenous populations, especially for women (see chart).

Labor. Labor force participation is higher and the rate of unemployment lower for indigenous people, who are concentrated in particular sectors of the economy, but they tend to earn lower salaries, work longer hours, and hold second jobs, making a high proportion of them "working poor." In Peru, 70 percent of indigenous women and 63 percent of indigenous men are involved in agricultural activities, on average earning only one third the salary of their nonindigenous counterparts.

As for the offspring, child labor force participation is greater for indigenous people than for nonindigenous people (9 percent versus 21 percent in Guatemala), with their incomes playing a substantial role in family incomes, especially as the children get older. Children of less educated parents, children of fathers who are employed as farmers, and children of mothers who are not in the labor force are more likely to work.

Why is it so bad?

After establishing a clearer profile of the indigenous populations in Latin America, the study next tried to determine why these people continued to remain the poorest of the poor. In other words, which factors interact with ethnicity to determine individual poverty?

The study first looked at the individual's earned income, trying to predict if the absolute level of income would stay the same if the individual's schooling attainment were higher. It found that income would definitely be higher. In Peru, it is estimated that the portion

of the overall earnings differential that is due to the productive characteristics of individuals is equivalent to about 50 percent. In other words, if indigenous workers were endowed with the same productive characteristics—such as education, experience, and health—as nonindigenous workers, the earnings differential between them would narrow by 50 percent. The remaining difference in earnings is "unexplained," picking up any unmeasured difference between indigenous and nonindigenous workers, including the effects of differences in ability, the quality of education, labor force attachment, culture, and, of course, labor market discrimination. Thus, increasing indigenous people's human capital would increase their earnings and lead to a considerable reduction in the overall earnings differential.

Next, the study looked at the poverty ratio, as measured by total per capita household income, trying to predict if the percentage of indigenous people that are poor would be higher or lower or the same if the level of human capital increased. Here the study found that the poverty ratio would drop. The results of a statistical analysis of the determinants of poverty in Bolivia reveal that being indigenous increases the probability of being poor by 16 percent. However, the probability of poverty increases by almost 45 percent for household members whose head of household is unemployed. This suggests that employment is more important than ethnicity. Among indigenous heads of household, being employed leads to a 40 percent reduction in the incidence of poverty. Also, increasing schooling attainment from zero to 16 years would result in a reduction in poverty among indigenous people from 60 to less than 30 percent. That is, the poverty ratio would decrease by more than half if schooling were increased. The connection, of course, is that more educated individuals are more productive and, therefore, better able to gain access to jobs that enable them and their families to leave the ranks of the poor.

What can be done?

These findings suggest that, fortunately, there is an unrealized potential. If policymakers concentrate on equalizing the human capital characteristics—that is, ensuring that indigenous people can obtain better schooling, training, and health services—much of the income differential between indigenous and nonindigenous people would disappear. This, in turn, would help alleviate poverty among a large segment of the Latin American population.

For education projects, knowledge about the indigenous population can aid in determining the location of new schools, targeting those with poor performance, and—when and if appropriate and in demand—providing bilingual education. On the labor front, institutional issues associated with the functioning of labor markets must be tackled. To some extent, indigenous people receive lower earnings and have a higher incidence of poverty because they are locked into the informal sector of the economy. This information can aid in the creation of appropriate employment generation schemes. Regarding health, a great deal more information is needed, but one clear priority would be providing medical care for pregnant women.

Finally, indigenous people should be involved in the design and implementation of development projects to ensure that "reforms" reflect the local inhabitants' goals—be they the integration or preservation of indigenous culture. In the case of education, for example, a lack of meaningful local participation could result in the loss of culture and language. Indigenous populations are different, and taking this into account means not imposing non-indigenous values. Any attempt to improve the conditions of indigenous populations would benefit from the consideration of "traditional" customs and expertise. ■



George Psacharopoulos
a Greek citizen, is Senior
Advisor to the Bank's Vice
President for Human
Resources and Operations
Policy.



Harry A. Patrinos
a Greek and Canadian citizen, is a Consultant in the
Bank's Education and
Social Policy Department.
He holds a doctorate from
the Institute of Development
Studies at the
University of Sussex.

For more details, see "Indigenous People and Poverty in Latin America: An Empirical Analysis," edited by the authors, Latin American Technical Department, Regional Studies Program, Report No. 30, World Bank, August 1993.

Housing Policy: Changing the Structure

STEPHEN K. MAYO

THE HOUSING sector plays a more important role in a country's welfare than many realize, directly affecting not only people's well-being but the functioning of other economic sectors. A challenging new policy agenda developed in light of worldwide experience sets out enabling strategies for the housing sector that give freer rein to economic forces.

More than one billion people worldwide lack adequate housing. In cities in developing countries, nearly 40 percent of the housing is unauthorized, and about half contains "squatters" with no legal claim to the land. Rarely permanent, located in unsafe locations, and often without access to potable water or adequate sanitary facilities, these crowded dwellings—where several people may call one room home—frequently wear price tags that match those in much wealthier countries.

Even in industrial countries, housing may not provide reasonable space, ventilation, or access to transportation. It may not be within a manageable distance of the residents' workplace, or it may simply be too expensive. In some Asian countries, for instance, rapid urban population growth and economic expansion have sent housing prices skyrocketing. In Japan, where housing costs are nine times what they are in Washington, DC, the average apartment for three people measures 485 square feet and, at \$450,000, will consume

an average of 11.5 years of income.

These and a multiplicity of other housing problems around the world are largely the result of failed policies. Their costs are reckoned not only in terms of homelessness and the dire conditions in which many people must live, but also in terms of the negative effects that spill over to other parts of the economy—degraded, unhealthy environments that affect residents' productivity; housing shortages that reduce workers' mobility, distorting labor markets; insufficient investment in residential infrastructure; and inflationary pressures caused by high land, house, and rental prices.

Housing policy fails under all types of governments and economic systems, in general for the same reason: a tendency to treat the housing sector as a social welfare "issue" rather than as a viable economic sector. Governments have too often tried to subsidize their way toward more and better housing, in the process overlooking the neediest groups, displacing private investment, and constructing expensive, badly designed buildings. The important role public investment in residential infrastructure plays in stimulating private housing investment has been largely ignored, and property rights have remained fuzzy in a financial climate that does little to foster much-needed long-term housing investment.

As evidence accumulates on the high costs of such misguided housing policies and the significant benefits of choosing the right ones, governments and international donors such as the World Bank have begun re-examining their approach to the housing sector. What has emerged is a new emphasis on the importance of market forces in creating an adequate supply of affordable, comfortable housing.

Rethinking the approach

In the 1970s, the principal objectives of housing policy in the developing world were building more housing for and supplying more

services to growing urban populations. To meet these objectives, governments built and subsidized housing and infrastructure and, in a number of countries, established regulations to control the housing prices and inputs.

But the "housing problem" just got worse—and, in 1988, the UN General Assembly endorsed the Global Shelter Strategy for the Year 2000, which called on governments to replace policies of direct intervention with enabling strategies. Defining such strategies required improved information about the nature of housing problems and the ways policy can mitigate them—a need that is being met by the Housing Indicators Program of the World Bank and the UN Center for Human Settlements.

Initiated in 1990, the program has collected data on key aspects of housing sector performance in 53 countries and developed new, richer housing measures that look beyond the question of whether a dwelling has four walls and a roof. Because traditional single indexes may actually hide more than they reveal, the new indicators take into account such factors as the quality of housing.

These measures suggest that although the problems facing the world's housing sectors differ, the causes—and the solutions—are often the same. Comparisons of the most important physical measures (such as crowding and structural durability), rents, house prices, and ratios of house prices to income show that lightly regulated markets provide better, more affordable housing, even for the poor, than heavily regulated markets. As part of a recent survey of the housing sector in Malaysia, econometric studies compared the country's complicated, cumbersome regulatory system to the simple, efficient system used in Thailand and found that Thailand's system generates a housing supply 30 times more responsive to shifts in demand. When housing demand, spurred by rising incomes, increases in Bangkok, construction of new

housing also increases, creating new jobs that boost incomes again and reducing house price-to-income ratios.

The failure of policy

When supply and demand are allowed to determine housing prices and quality, high employment levels and income growth will translate into demand for more and better dwellings. In these situations, it is reasonable to expect housing conditions to improve as economies expand. But evidence shows that this is not necessarily what happens.

Even among countries at the same level of economic development, quality and cost of housing, access to formal credit and residential services, and leasing or buying arrangements vary. Estimates put house price-to-income ratios in Karachi, Pakistan at one quarter of those in New Delhi, India, despite the fact that the two cities' per capita incomes are roughly comparable. Formal housing finance covers the cost of some 58 percent of new residential construction in the Philippines, but of only 8 percent in Côte d'Ivoire. An estimated 12 percent of Beijing's housing stock falls into the "unauthorized" category, compared with 48 percent in New Delhi and 51 percent in Karachi. Caracas and Rio de Janeiro have similar per capita incomes, but 30 percent of the dwellings in Caracas have no access to running water, as opposed to just 3 percent in Rio de Janeiro.

These differences are the result not of culture, climate, or topography, but of policies related to the supply of and demand for housing. Market-oriented, often innovative policies have had dramatic results. When dwellings in Manila and Medellín were provided with basic services, for instance, community residents spent enormous amounts of their own money to upgrade their houses. In the early 1980s, before the Chilean Government stopped building subsidized housing, the Housing Ministry had swollen to some 30,000 employees and was producing, on average, fewer than 10,000 units each year. After slashing the ministry staff to 3,000, the government introduced a voucher system to help people pay for private housing, and annual production of housing for low- to moderate-income families more than quadrupled. A large part of Thailand's suc-

Housing crisis in the United Kingdom

Housing policies in the United Kingdom have traditionally involved heavy state intervention in private land and housing markets, emphasizing public construction and ownership of Council Housing (state-subsidized housing), rent control, stringent planning regulations, and greenbelts around cities. Despite reforms instituted by the Thatcher Administration, including the selling of Council Housing, these well-intentioned policies created a rigid, unresponsive housing supply system that during the 1980s was unable to meet demand, particularly in the greater London area, without a sharp increase in housing prices.

Recent research suggests that high housing prices have affected the United Kingdom's overall macroeconomic performance. Household savings declined dramatically during the financial liberalization of the 1980s, apparently because households, believing they had more money, were willing to take advantage of the new rules that allowed them to withdraw part of their home equities as refinanced mortgages. After providing an initial boom in consumption, this drop in personal savings resulted in less financing for the business community.

As in most countries, the business sector in the United Kingdom is a net borrower and the household sector a net saver, so when household savings declined, upward pressure was put on interest rates. These pressures eventually led to increased inflows of foreign capital and a deterioration in the balance of payments capital account. The balance of payments current account also came under pressure, since households that withdrew home equity often purchased imported goods.

At the same time, the soaring housing prices in the greater London area tended to prevent unemployed workers—primarily from the north of England and Scotland—from moving to an urban environment where they might find jobs. Estimates put the overall unemployment rate at some 2 percent more than it would have been had workers been able to move freely to look for work.

Source: Minford, Patrick (1989), "Effects of Housing Distribution on Unemployment," *Oxford Economic Papers* 40(1): 322-46; and Muehlbauer, John and J. Murphy (1989), *Why Has UK Personal Savings Collapsed?* (Report prepared for Credit Suisse, Basle and London Offices).

cess has been due to the rapid expansion of commercial mortgage lending: mortgage volumes have grown at rates of over 30 percent annually for over a decade.

Policies that constrain market efficiency result in reduced investment, expensive and shoddy housing, and a low-quality residential environment. Such policies are often particularly inimical to the functioning of the rental housing sector, which serves the bulk of the developing world's urban populations. Many public sector housing programs are not cost-effective, and subsidies have been unfairly distributed among civil servants or the military. In Argentina, the system of housing finance and subsidies in the 1980s was viewed as an "automatic destabilizer" responsible for an estimated 25 percent of the country's high inflation—the result of unchecked increases in subsidies, which in some cases were more than the value of the housing itself. In the United Kingdom, where housing prices soared in the 1980s, the lack of mobility caused by the housing crunch was a factor in constraining employment (see box).

Finally, while microeconomic policies directed at the housing sector clearly affect the performance of the sector itself, they also influence the performance of the economy as a whole. In most countries, investment in public and private housing typically accounts for 2-8 percent of GNP and the flow of housing services for an additional 5-10 percent. More important, housing sector performance is intertwined with the national economy through real, financial, and fiscal circuits. Traditional thinking has used real linkages, which include investment, employment, and prices, to justify housing's role as "leading sector" in the economy. But restrictive rules and regulations keep housing demand from translating readily into supply and employment. Thus, a new view of the importance of real linkages has developed that not only stresses the need to remove impediments but allows markets to respond to demand and accepts that the housing sector's role in the national economy often depends on financial and fiscal as much as on real linkages.

The \$300 billion cost to American taxpayers of the "savings and loan scandal" provides graphic evidence of the cost of unchecked deregulation and poor oversight of housing finance institutions. Similarly, the coexistence in Eastern Europe and the states of the former Soviet Union of generous housing subsidies (which often absorb 5 percent or more of GDP) and widespread housing shortages (which may leave one sixth of a country's households with only shared dwellings) clearly demonstrates that incurring a heavy fiscal burden for housing is good for neither the housing sector nor fiscal integrity.

Enabling housing policy

Some countries, including Thailand, have escaped the housing sector crisis gripping many of their neighbors. Despite its relatively low per capita income (\$1,000 in 1990), Thailand has a supply of adequate, affordable housing. The most common housing unit under construction in Bangkok is the low-rise condominium, which even households with incomes well below average can afford. Chile and Colombia have adopted innovative policies, including housing vouchers and indexed deposits and loans, to create more housing

and stimulate broader economic reforms in financial and social policy.

Governments have at their disposal seven major enabling instruments (see table) that can be adapted for use in most countries. For instance, low-income countries often need to emphasize infrastructure investment, building industry competition, and property rights. Former centrally planned economies need to focus on property rights, housing finance, subsidies, land and building regulations, land development, materials production and distribution, and the residential construction industry. In highly indebted middle-income countries, the key priorities are fiscal and financial policy reform—particularly improving housing finance institutions and reducing budgetary transfers to the housing sector—as well as expanded infrastructure development. And in other middle-income countries, regulatory reform in land use and building and increased opportunities for mortgage financing are the key issues.

The World Bank responds

Last year, the World Bank, one of the largest lenders to the housing sector (an average of \$1–2 billion annually for the last five years), issued its first housing policy paper since 1975, *Housing: Enabling Markets to Work*. The paper advocates replacing traditional project-based support of public housing agencies with a broader objective: reforming government policy, institutions, and regulations so that housing markets function more efficiently.

Despite their success in producing housing and targeting those most in need of it, previous Bank-supported projects often had few effects on overall housing policy. In some projects, for instance, the financing provisions and land use and building regulations applied were literally against the law outside project boundaries. The Bank's new approach is to support government enabling strategies, including adjustment lending, investment lending, and technical assistance operations. For low-income countries, these investments often involve slum upgrading and rehabilitating urban infrastructure systems. Projects in Angola, Benin, and Mozambique have focused on urban rehabilitation as the key to addressing shortfalls in residential infrastructure and to stimulating the urban economy as well as land and housing markets.

For those low- and middle-income countries and former centrally planned economies with comparatively underdeveloped financial sectors (e.g., Indonesia and Poland), loans are likely to support projects designed to improve overall financial intermediation. In other middle-income countries, the emphasis is on

Enabling housing markets to work	
Instruments	Enabling strategies
Developing property rights	Regularizing land tenure, expanding land registration, privatizing public housing stock, taxing property
Developing mortgage finance	Permitting private sector lending at positive/market rates, enforcing foreclosure laws, ensuring prudential regulation, introducing improved loan instruments
Rationalizing subsidies	Making subsidies transparent, targeting the poor, subsidizing people (not houses), reviewing subsidies
Providing infrastructure	Coordinating land development, recovering costs, basing provision on demand, improving slum infrastructure
Regulating land and housing development	Simplifying complex regulations, assessing regulatory costs, removing price distortions and artificial shortages
Organizing the building industry	Eliminating monopoly practices, encouraging small firms, reducing import controls, supporting building research
Developing an institutional policy framework	Defining public and private sector roles, creating a forum for managing the housing sector as a whole, developing enabling strategies, monitoring sector performance
Source: <i>Housing: Enabling Markets to Work</i> , World Bank Policy Paper, 1993.	

reducing unnecessary regulatory costs and improving the housing delivery system. In Korea, for example, a recent loan has used sectoral performance indicators to target necessary regulatory reforms. In Mexico, Bank loans have helped reduce regulatory costs and housing subsidies, ensure that subsidies go to those who need them, liberalize land tenure, and support expanded private sector participation (see box on Mexico). Most recently, Mexico has received a Housing Market Development Loan that will help finance government measures to deregulate the housing sector and encourage private banks and builders to enter the lower-income segment of the housing market.

The high stakes of policy

As the alarming dimensions of housing policy failures become front-page news across the world, and as more and better data on the housing sector's role in the economy accumulate, the benefits of a well-functioning housing sector are becoming increasingly evident. The poor bear the brunt of housing market failures, but nearly everyone loses in some way. Too often, dysfunctional housing supply systems tend to produce their own pathology of policy responses—rent control, slum clearance, heavily subsidized public housing, below-market interest rates for housing loans, and a host of other policies—that deal only with the symptoms of the original policy failures.

These responses further distort markets and result in large benefits for the lucky few and widespread costs for everyone else. In many cases, the biggest losers are exactly

those groups that housing policies are intended to benefit. And frequently, the costs reverberate through the broader economic system, affecting investments in other sectors, savings rates, budgetary deficits, inflation, interest rates, labor markets and labor productivity, and even the balance of payments. The ubiquity and magnitude of these costs underscore the need to get housing policy right. ■



Stephen K. Mayo
a US national, is a
Principal Economist in the
Bank's Urban
Development Division. He
earned his PhD at
Harvard.

For more information, see *Housing: Enabling Markets to Work*, World Bank Policy Paper, 1993.

Housing Reforms in Mexico

THOMAS L. ZEARLEY

Senior Financial Analyst, Latin America and the Caribbean Region, The World Bank

OVER THE past decade, Mexico has invested about 4-5 percent of GNP in housing—about the same as other countries at a similar stage of development. But this level of investment has not been enough to prevent Mexico's housing conditions from deteriorating. At present, the government estimates that about 3 million additional units are needed to adequately house the country's 83 million inhabitants. Mexico's housing problems are intensified by moderate population growth, rapid urbanization, and an imbalance in people's ability to pay for their housing. As much as 70 percent of the population can obtain mortgage credit only from public sector programs.

Beginning in the mid-1960s, as macroeconomic conditions in Mexico worsened and the fiscal deficit ballooned, the government realized that the earlier approach to the nation's housing problem, which had relied heavily on public sector intervention, was unrealistic and unsustainable. Instead, the government sought to redefine its role in housing and to create a more favorable environment for expanding private sector initiatives in financing and building affordable housing. The government also decided to strengthen the operations and financing of public housing sector programs for the poor.

The recent reforms made by the Mexican Government to improve the functioning of the housing market embrace many of the strategies recommended in the World Bank's new housing policy statement. The Bank has strongly backed the reform program and since 1985 has approved four housing loans to Mexico that total more than \$1.2 billion. This article describes these reforms, illustrating how developing countries can overcome obstacles and put into practice the key features of the new housing policy statement.

Demand-side constraints

Mexico has devoted considerable attention to developing housing finance. In the mid-1980s, when inflation climbed to nearly 170 percent, the government authorized an innovative "dual rate" mortgage instrument, which allows lenders to charge market interest rates on mortgage loans and link borrowers' repayments to adjustments in wages,

capitalizing differences and extending the terms of the loan. This type of instrument has made mortgage lending attractive to lenders and affordable to borrowers under inflationary conditions. Even though inflation in Mexico has fallen to less than 1 percent a month, the "dual rate" mortgage instrument is still commonly used. In 1990, the government privatized the commercial banking system, which had been nationalized in 1982. Bank regulators have also amended rules to facilitate branch banking and the creation of specialized financial intermediaries in order to better serve small savers and home borrowers.

In 1992, the Mexican Congress passed legislation overhauling the nation's compulsory pension fund and a related, large worker-run housing program. These reforms have substantially increased the volume of long-term financing available to commercial banks for mortgage and other lending and improved the transparency and financial self-sufficiency of the workers' housing fund.

The government has further addressed demand-side constraints by reducing housing subsidies and better targeting them. The Mexican authorities have estimated that during the mid-1980s, when inflation rose to record levels, commercial banks were subsidizing home borrowers by as much as \$300-500 million a year in the form of mandated below-market rate loans. In 1989, the government removed controls on commercial bank interest rates on deposits and loans and eliminated mandatory lending requirements for housing and other activities. Subsidies were also cut when the central bank announced that loans provided from its special fund for low- and moderate-cost housing would be awarded to home builders and, eventually, to home buyers through public auctions rather than by direct placement.

Measures have also been taken to relieve constraints on property rights development. During the past several years, federal and state officials have legalized over 1.2 million properties occupied mainly by low-income households. With clear title to their land, occupants can now offer land as collateral to secure credit for home improvements and other purposes.

Supply-side constraints

The government has also implemented

measures to remove supply-side impediments. Surveys of home builders and others indicate that regulatory costs related to the urbanization, construction, and transfer of a new home can add as much as 25 percent to the cost of a house. Excessive regulatory costs often discourage low-income households from seeking formal sector housing, as these households generally are unable to afford both the up-front regulatory fees and the loan down payments. To reduce these costs and to make them more transparent, the federal government has agreed with state and local governments on guidelines for reasonable building standards, time limits for permit approvals, and specific targets for lowering bureaucratic costs.

To relieve bottlenecks in the urban land market, the government, as part of a broad program to modernize Mexico's agricultural sector, has passed laws that will allow communal landholders to associate themselves with private investors or to sell their land to builders for housing development. The action is critical because the more than 50 percent of Mexico's land that is communally held surrounds the country's fastest growing cities.

To address infrastructure shortages related to housing, the government has increased public investments in water supply and sanitation facilities, urban roads, and electricity networks. In addition, the government has begun to promote private sector investment in infrastructure development through concessional and partial guarantee arrangements.

The government has also been supportive of the home building industry, helping establish wholesale markets for materials and disseminating information about new construction techniques. The government hopes that the North American Free Trade Agreement will heighten competition from abroad, pressuring domestic home builders and suppliers to be more productive and speeding up the introduction of new technologies and home building procedures. ■

For more information, see Thomas L. Zearley "Creating an Enabling Environment for Housing: Recent Reforms in Mexico," *Housing Policy Debate, Federal National Mortgage Association, Vol. 4, Issue 2, 1993.*

BOOKS

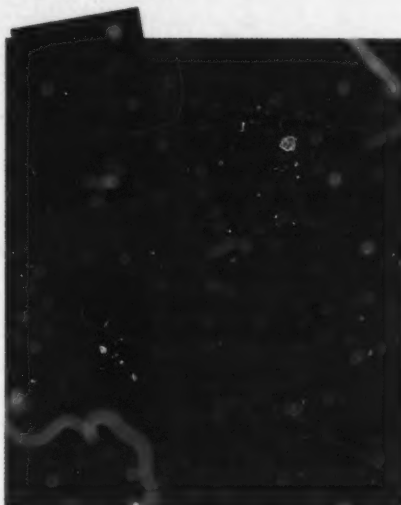
Chronic Inflation 20 Years Later: A Progress Report

Over 20 years ago, in his well-known study *Chronic Inflation in Latin America* (New York: Praeger, 1972), Felipe Pazos convincingly argued that the inflation strain that had afflicted several Latin American countries from 1949 to 1970 had been quite different from the hyperinflations that had ravaged Europe after the two world wars. While the hyperinflations had been characterized by short and explosive outbursts of extreme inflation, Latin American inflation, although higher than in industrial countries, had been relatively stable and, to a great extent, self-sustaining. During the 1970s, Israel had the dubious honor of joining the, hitherto Latin American-only, club of chronic-inflation countries. After several failed attempts, and with inflation running at an annual rate of close to 400 percent, the July 1985 Israeli stabilization plan achieved a quick and lasting reduction of inflation to levels around 20 percent a year.

The two books under review were inspired by Israel's experience with chronic inflation and disinflation. Although quite different in spirit and approach, both books make for exciting reading. Bruno's book is largely nontechnical, policy-oriented, and aimed at a broad audience. It also provides a rare, and quite fascinating, insider's look at the trials and tribulations of policymaking. In contrast, Leiderman's book is a collection of papers, grouped under five major topics, most of which were published in top academic journals over the last 10 years. A reading of these books suggests that, 20 years after Pazos's pathbreaking contribution, many of the issues underlying the phenomenon of chronic inflation remain as topical and controversial as ever.

In the tradition of Pazos, the notion of inflation inertia is the leitmotif in Bruno's book. Inflation inertia, in Bruno's view, refers to the highly persistent nature of inflation due to backward-looking wage indexation, slowly adjusting inflationary expectations, and accommodating monetary and exchange rate policy. In the presence of inflation inertia, Bruno argues, price shocks can translate into permanent increases in inflation. The stepwise profile of inflation in Israel from 1973 to 1985 can

thus be explained by a series of shocks (oil price increases, cuts in subsidies, and step devaluations), and the subsequent accommodation through the linkage of key nominal variables (the exchange rate, prices, wages, and money) to past inflation. Such a process of "shocks and accommodation"



leaves the economy with no nominal anchors. Inflation thus acquires much of a life of its own, independent of the fiscal problems that originated it.

Bruno's best efforts notwithstanding (Bruno, like Pazos, is at his best when discussing inflation inertia), it is hard to escape the feeling that inflation inertia remains one of those elusive, catchall concepts that often raise more questions than they answer. (The fact that common sense tells us that it is an important notion makes this state of affairs all the more distressing.) Leiderman, of course, does his best in reinforcing whatever qualms the reader may have had when he argues that the existence and relevance of inflation inertia remains an open empirical question. The mere finding, Leiderman claims, that inflation is persistent over time (which is Bruno's empirical measure of inflation inertia for Israel) does not necessarily imply that the inflation rate is fundamentally sticky or predetermined (which is Leiderman's definition of inflation inertia).

He illustrates this point by building a model in which inflation may be highly persistent over time even though, by construction, the inflation rate is not sticky. In Leiderman's view, a proper test of the hypothesis of inflation inertia would require empirically testing a model that embodies it. Perhaps more disturbing are Leiderman's findings that shocks in Israel have, by and large, not given rise to long-term inflation persistence, and that most fluctuations in inflation have been primarily transitory. Curiously enough, however, in the introductory chapter Leiderman seems to side with Bruno on the importance of inflation persistence in Israel, in spite of some of his own earlier findings.

The empirical relevance of inflation inertia is crucial for the discussion on the desirability of price and wage controls in a stabilization plan. (Neither author disputes the need for a fiscal adjustment to ensure a successful disinflation.) Bruno advocates a coordinated freeze of the exchange rate, prices, and wages (the heterodox approach) to break the self-momentum, or persistence, of inflation. In contrast, Leiderman takes a much more skeptical position on the usefulness of the heterodox approach. Bruno heralds Israel, as well as Mexico, as prime examples of the critical importance of the heterodox approach in chronic inflation countries. As evidence of the failure of the orthodox approach, Bruno cites the Chilean program of the late 1970s (the *tablita*), in which the exchange rate was eventually fixed at the same time that, by law, nominal wages were fully indexed to past inflation.

Although it is hard to disagree with Bruno on the Chilean case, his attempt to generalize about the orthodox approach based on Chile's case is less convincing. Undoubtedly, formal backward-looking indexation will make the inflation rate sticky and might, therefore, call for the heterodox approach if, as argued by Leiderman, that is the only way (for political reasons) of cutting the link between nominal wages and past inflation. The mere fact, however, that inflation is persistent—due to, say, policy accommodation or an incredulous public—appears to provide a much weaker case for the heterodox approach.

In the April 1991 Convertibility plan in Argentina, for example, the exchange rate was fixed without controlling for any other nominal variable (a prime example of orthodoxy in a country with five decades of chronic inflation). The success of the plan would suggest that, as long as inflation persistence is not due to formal backward-looking wage indexation, a credible stabilization plan based on an active (i.e., non-accommodating) exchange rate policy may be enough to ensure a rapid fall in inflation. In such a case, the well-known costs of price and wage controls (on which both authors agree) might offset the benefits. The reader is also left wondering why, if in Bruno's view the Uruguayan *tablita*—implemented with a balanced budget and with no major problems of formal indexation—was a policy mistake, fixing the exchange rate in the Convertibility plan was not. Clearly, from an ex-ante point of view (which is what matters for policy decisions), both plans looked quite similar in terms of their "orthodoxy." If, as many would argue, the key difference between the two programs lies in the accompanying structural reforms, it would be an indication that such reforms, rather than the "heterodox" components, are critical to success.

A related issue, as Leiderman argues, is

that the response of key macroeconomic variables to major stabilization plans in chronic-inflation countries has been very similar, regardless of whether the plans were orthodox or heterodox. Typically, there has been an initial expansion in economic activity in spite of an appreciating real exchange rate. The contractionary costs associated with disinflation have appeared only later in the programs. Hence, even if the heterodox approach were to alleviate some of these problems (say, the real appreciation), it does not seem to fundamentally alter the underlying response of the economy. Such findings, which suggest that other, more basic reasons lie behind this common pattern, thus call into question Bruno's emphasis on heterodox components.

Leiderman argues that lack of credibility, generally expected in countries with a history of high inflation and countless failed attempts, may explain this post-stabilization business cycle. Bruno disagrees with this hypothesis (at least for the Israeli case) and suggests that the initial boom, which he attributes to an increase in perceived financial wealth, simply delayed a recession caused by the protracted structural crisis in Israel (which was reinforced by the *Intifada* and the real appreciation). Whatever merit Bruno's

position on Israel may have, however, it clearly cannot account for the similarity of experiences across countries.

In summary, these books provide a stimulating intellectual journey through the world of chronic inflation and stabilization. In addition to the issues discussed (which are the more controversial), the books cover many other related issues, ranging from Leiderman's formal look at the interaction between budget deficits and inflation to Bruno's discussion of stabilization in Eastern Europe. The arguments are well presented and clearly articulated. Even when readers disagree, they are forced to critically re-evaluate (and often revise) their own position, a valuable exercise in itself. Given that Bruno's book is policy-oriented while Leiderman's is academic, it is only natural that they differ markedly in style. Bruno writes with the vigor and enthusiasm of an insider, Leiderman takes a more detached view; Bruno takes a stand on almost every issue, Leiderman is more cautious; Bruno seeks to persuade, Leiderman seeks to question. Fortunately, there is no need to choose, and any serious (and not so serious) student of the subject should place both books alongside Pazos's classic study.

Carlos A. Végh

The public debate on trade policy reflects broad agreement among economists on the benefits of open world trade. This view is not based on naïve assumptions about perfect markets; rather it recognizes the massive government failures arising from special interest politics and bureaucratically managed trade. Even those who have developed the new "strategic trade theory," which establishes the case for intervention in the presence of monopolistic advantage in production, generally recognize that governments are very unlikely to improve matters by attempts to implement strategic trade poli-

cies. Moreover, the "new growth theory," with its emphasis on market incentives for introducing new products, has generally reinforced the case for open trade policy. Unfortunately, agreement among economists on these matters does not extend to the general public.

Patrick Low describes the threats to the multilateral system from protectionist forces in the industrial countries, especially the United States. The author's treatment of his complex material is precise and persuasive. At a time when many developing countries are moving toward more open trade and investment policies,

or are showing serious interest in doing so, Low notes that the multilateral trading system is under severe strain. Not only have protectionist pressures grown in industrial countries, but the commitment of governments to a predictable, rules-based approach to trade policy has weakened.

Low argues that the growing emphasis on "fair" trade in the policy debate has allowed lawmakers to promote protectionist outcomes without taking responsibility for them—blaming foreign malfeasance deflects protectionist stigma. The decisionmaking process in the United States, built on competitive tension between the

administrative and legislative branches of government, has muffled the articulation of the national interest in trade policy matters. Traditional US leadership in defending an open world trading system has diminished, and neither the European Union nor Japan has shown signs of taking up the slack. Low's book was written at a time when repeated attempts to complete the Uruguay Round of multilateral trade negotiations were failing, which the author characterized as symptomatic of the malaise. Now that the Uruguay Round has been completed, it would be interesting to know whether the author would modify his thesis.

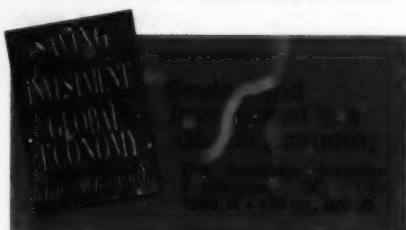
The authors of the 15 conference papers edited by Ito and Krueger present a variety of views, but all agree on the desirability of market-directed trade and emphasize the importance of the politics of trade policy. Many of the papers describe how aggressive US policies look from the perspective of Korea and Taiwan Province of China (where US threats have

tended to result in acquiescence in opening of the domestic markets, but with considerable resentment). Gary Saxonhouse argues that the relatively low level of Japanese imports of consumer goods results from its economic structure rather than from cultural bias or conspiratorial behavior. An interesting chapter by Robert Baldwin and Douglas Nelson describes concisely the evolution of US and Taiwanese trade policy, both in general and in relation to each other. The theme of the autonomous state, which is losing its autonomy in both cases, plays a prominent role in their discussion. In both cases they argue that intellectual arguments were important influences on trade policy, during the periods in which state autonomy was relatively high. In another paper, Richard Snape comes out strongly in favor of multilateralism rather than the regional approach that is currently in favor in US policy circles.

How realistic are these arguments in favor of a completely open world trading

system? Free trade economists may finally have to come to terms with the fact that we are not going to get all that we want. We should continue to be clear on the virtues of a fully open system, but we should also be clear on the priorities when compromises have to be made. The calculation of welfare losses may be a misleading guide to what matters most in trade policy. Trade is probably most important for its ability to weaken distributional coalitions, promote technical progress, and perhaps foster reasonably harmonious international relations, reducing the probability of war. Economists need to continue to pursue the topics treated in these two books in order to contribute to the evolution of a trading system that will retain the support of the diverse nations of the world and the people within those nations.

*Christopher Clague
Professor of Economics
University of Maryland*



This book is a valuable addition to the literature on international adjustment, combining as it does a survey of existing empirical results with a wealth of new information. Bosworth first elucidates and then examines the "conventional model" that links the domestic and international economies.

The model consists of three links: differences in desired levels of domestic saving and investment lead to changes in domestic interest rates (for example, if desired saving is lower than desired investment, interest rates rise); higher interest rates attract international capital while at the same time raising the value of the exchange rate; the appreciation in the exchange rate induces a deterioration in the trade balance, creating a rise in imports and a fall in exports—a necessary counterpart to the inflow of capital. How

well does this model explain the trends in current account surpluses of the 1980s, a period that saw unexpectedly large current account divergences across the major industrial countries? The book focuses on answering this question.

Bosworth outlines these links in the introductory chapter and, anticipating his conclusion, adds that "the conventional model of international macroeconomics works surprisingly well in explaining macroeconomic developments over the 1980s." The second chapter discusses the conventional model in more detail and is followed by three chapters that look at the empirical results for the crucial building blocks in the model—trends in saving and investment, determination of exchange rates, and the factors affecting exports and imports. In a particularly welcome departure from the approach of many US economists, the original work in the book (and there is quite a lot of it) focuses on behavior across a wide range of industrial countries, not simply the largest ones.

The importance of the book lies in these empirical chapters. All three provide a valuable guide to empirical work in the area and extensions to existing results. The analysis of saving and investment

trends across countries is particularly informative and serves as a useful antidote to those who regard international imbalances purely as a function of disembodied external inefficiencies, such as (in the case of the United States) access to Japanese markets or the level of the exchange rate. The holistic approach of the book, showing how changes in underlying variables led to movements in the current account, is also very useful.

If there is a problem with the book, it is not in the nuts and bolts of the empirical chapters, but in Bosworth's overall assessment of the conventional model. The model still leaves several anomalies unexplained. If international capital markets are highly integrated, why are movements in the private saving-investment balance largely offset by movements in the government saving-investment balance, rather than in the current account? Why are floating exchange rates so variable from day to day? These and other questions, although discussed in the text, might make one less sanguine than Bosworth about the overall health of the conventional model. In this sense, parts of the book add up to more than the whole.

Tamim Bayoumi



Economists endlessly debate why some nations—most recently the East Asian ones—do better than others. Is it good or bad government policy that determines success? Is it foreign aid or colonial exploitation? Lawrence Harrison, a former mission chief for the US Agency for International Development, offers a seductively simple alternative: culture is the decisive factor in economic success. Sounds intriguing—but the book is utterly unconvincing in its arguments.

The cultural theory of success is like a shiny used car—it looks good on the lot, but when you try to drive it, the wheels fall off. The theory has a problem: cultures are long-lasting, while economic success is sudden and short-lived. Explaining a few decades' growth by a millennia-old culture is like attributing a hot summer day to global warming. Take Harrison's discussion of Korea's success, which he attributes to the Confucian ethic of hard work and high saving. But wait a moment—isn't that the same Confucian ethic that in the early 1960s had given Korea a saving rate of 3 percent of GDP and left it one of the world's poorest nations?

Harrison frankly acknowledges these difficulties—one of the charms of his book is that he evenhandedly presents evidence on both sides. His answer is that the negative aspects of Confucianism—authoritarianism and disgust at commerce—had dominated the scene for millennia but then that the "latent positive forces"—frugality and veneration for education—fostered the takeoff of Korea and other Asian "miracles." Alas, such a theory is of little use for predicting who is going to succeed; how are we to know on what side of the bed Confucianism is going to wake up tomorrow morning?

Harrison's other argument is that culture can change. Here he at times indulges in circular reasoning. The problem is that we have no objective measure of culture by which we can see it change. The book says that the Korean economy had rapid growth because the culture improved. And how do we know that the culture improved? Because the economy had rapid growth!

Harrison similarly bobs and weaves when attacking the "Iberian" heritage that allegedly suffocates Spain and Latin America. But did not Spain have rapid economic growth the last few decades? His explanation: they opened up to other Europeans and US citizens, through both foreign direct investment and "a surge of tourism"! He argues that it was helpful that the Spaniards "eliminated the visa requirement for Western Europeans and Americans." According to Harrison, when East Asian nations do well, it is the "latent positive forces" in their own culture; when Spain does well, it is the influx of foreign culture.

Spanish-speaking cultures are not given a break in this book. Is Costa Rica a model of democracy? The book speculates that it was, because there were "large numbers of Basque and Catalán immigrants" in Costa Rica. To explain political strife in the rest of Latin America, the book makes the portentous claim that there is no word for "compromise" in Spanish (is there one in Basque?). Actually, the claim is wrong: the Spanish words *acuerdo* or *consenso* will do just fine.

The book's description of some of the stultifying aspects of the culture of poor people, such as lack of planning for the future, is more convincing. But the book slights the possibility that it is reverse causation—poverty causing culture, not culture causing poverty. People close to subsistence find it difficult to save. Indeed, the book itself shows this and other adverse cultural traits to be universal among poor people, including poor people from the cultures that Harrison admires.

Harrison is right that blaming colonialism or *dependencia* for underdevelopment is not very persuasive. But neither is blaming culture. In one view, we have the poor who blame their poverty on others, and in the other, we have the prosperous who attribute success to their own virtue. Between these extreme views, maybe there is a lot to be said for the old-fashioned economist's view that people are the same everywhere and will respond to the right economic opportunities and incentives.

William Easterly

Japanese Capital Markets Edited by Shiro Kawai Japan Center for Economic Research Publication University of Chicago Press, Chicago, IL, USA 1988, pp. 254, \$25.00	Japan's Monetary Policy National Bureau of Economic Research Publication University of Chicago Press, Chicago, IL, USA 1988, pp. 254, \$25.00	The Japanese Experience of Economic Reforms Japan Center for Economic Research Publication Macmillan Press Ltd, London, UK, 1988, pp. 254, \$25.00
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Japan's phenomenal postwar growth performance and its emergence as an economic superpower in the early 1980s have aroused renewed interest in the Japanese economy and the characteristics of its policy framework. The contributors of these three volumes offer valuable

insights into the strategic factors that have accounted for Japan's economic success by examining three areas of its economy—the functioning of capital markets, the evolving monetary system, and the process of economic reforms during 1945–70. These volumes, particularly

Teranishi and Kosai's, are also relevant to the former centrally planned economies and developing countries. Takaji's *Japanese Capital Markets* traces the evolution of Japanese capital and related markets since the gradual relaxation of controls in 1975. Not only has the size of

Japanese capital markets increased—they now rank with those of the United States—but their structures have also changed substantially in recent years. This widening and deepening of capital markets has induced new research in such areas as the cost of capital (Jeffrey Frankel), corporate financing practices (James Hodder and Adrian Tschoegl), the pricing of Japanese stocks (Hideki Hanaeda; Shinji Takagi), and stock trading rules (Hideki Kanda). The authors of the 16 chapters in this volume explore these areas, covering institutional, analytical, and policy issues.

Japanese Monetary Policy discusses the evolution of monetary policy and its instruments, particularly since 1980. The book emphasizes a peculiar characteristic of Japanese monetary policy: the impact of monetary policy is transmitted to the real sector through changes in credit availability rather than through changes in the money supply. This unusual trait is the result of the reliance of the major commercial banks (city banks) on credit from the Bank of Japan—a reliance that enables the Bank of Japan to use administrative guidance and the discount rate as effective instruments of monetary policy. The research presented in this volume suggests that the institutional setting in which monetary policy was implemented during 1955–88 has substantially influenced real economic activity in Japan.

However, the volume does not adequately emphasize that this institutional setting, within which interest rates and the bond market are heavily regulated and the financial system is under the general con-

trol of the Ministry of Finance and the Bank of Japan, is the result of a deliberate government strategy to develop a bank-oriented financial system.

The last and perhaps most interesting volume, *The Japanese Experience of Economic Reforms*, provides a fresh investigation by Japanese experts into various aspects of economic reforms in post-war Japan. The book focuses on economic reforms, structural changes, and inflation control during 1945–50, although the long-term trends of deregulation and liberalization are also taken into account. It is important to note that the system that emerged after the reforms was by no means a pure market-based system; instead, it was characterized by a substantial degree of government intervention.

An important characteristic of Japanese reforms, according to Teranishi, has been the gradual and protracted nature of the processes of deregulation and liberalization. They have been designed to provide firms with non-neutral (discriminatory) incentives—through protection, subsidies, subsidized credit, and tax measures—to adopt, adapt, improve, and diffuse modern technology; attain international competitiveness; and promote a viable process of import substitution and export promotion. Thus, until at least 1973, government intervention (through various instruments) was critical to the unique, high annual growth rate—about 10 percent—Japan experienced during 1953–73.

Further, the growth- or production-oriented stabilization policy the government adopted during 1945–50, which was

in direct opposition to the more orthodox policies recommended by the World Bank and the IMF, made it possible for Japan to attain macroeconomic stability along with substantial increases in industrial output. Such selective, purposive, discriminatory interventions, according to the neoclassical perspective and the emerging consensus on development theory, are dysfunctional; however, in the case of Japan, they have been not only functional but also very effective in accelerating the pace of development.

This volume, however, does not deal with several significant aspects of the Japanese institutional and policy framework. First, what measures were taken to make the state industrialization ideology acceptable to farmers, industrial labor, and private firms? Without such acceptance, state interventions would have been ineffective. Second, how did various coordination mechanisms evolve so as to create a highly competitive environment within a cooperative framework? In many developing countries, the stabilization and structural reforms quite often do not provide the expected results because of the lack of appropriate coordination mechanisms. Third, how did the highly competent and motivated Japanese bureaucracy evolve with such a high degree of integrity? Without its bureaucracy, Japan could not have formulated and implemented growth-inducing government interventions.

V.V. Bhatt

BOOKS in brief

Richard O'Brien (editor)

Finance and the International Economy: 7

The AMEX Bank Review Prize Essays

Oxford University Press, New York, NY, USA, 1993.
vi + 161 pp., \$14.50.

This volume contains a number of interesting and provocative essays, many of them challenging traditionally held views. Richard Brown and DeAnne Julius confront the proposition that manufacturing is somehow special, the foundation for economic prosperity. They conclude that this is not so and that the structural

shift in industrial countries toward services is natural and a viable basis for continued growth. The conventional wisdom that central bank independence leads to greater price stability is challenged by Adam Posen, who rejects any simple institutional causality. Rather, he maintains, it is the coalition of politically influential interests, represented by a developed financial sector, that provides crucial support for anti-inflationary policies.

The factors behind East Asia's dramatic performance are examined by Dipak Dasgupta; effective government policies, a dynamic private sector, and a demonstration effect explain

the remarkable (and allegedly replicable) performance. Holger Wolf suggests that the European Union should be *broadened* (rather than *deepened*) to incorporate the East European economies. Other essays in the collection include the narrowing of returns between stocks and bonds (Olivier Blanchard); changes in pension fund financing in Europe (Philip Davis); the relationship between economic growth and financial markets (Palle Anderson); and some of the policy choices for developing countries that unite with developed countries in economic groupings.

Harry T. Oshima

Strategic Processes in Monsoon Asia's Economic Development

Johns Hopkins University Press, Baltimore, MD, USA, 1993, vii + 285 pp., \$55.

For the economies of monsoon Asia, the adage, "everybody talks about the weather, but nobody does anything about it," has a particular resonance. The yearly cycle of six months of heavy rain and six months of little rain has produced a highly labor-intensive agricultural activity—rice paddy cultivation. But the large rural labor force needed to produce maximum yield during the rainy season cannot find sufficient work in the dry half of the year.

Some monsoon economies, such as Japan, the Republic of Korea, and Singapore, have escaped the stagnation and poverty imposed by the seasonality of Asia's rains. But others, like Bangladesh, India, Indonesia, and the Philippines, are still trying to break out of the vicious circle of low employment and minimal productivity gains, leading to further increases in the demand for labor and even more concentrated rural population densities. Oshima, Professor Emeritus of economics at the University of Hawaii, compares the experiences of the monsoon economies and suggests a number of policy prescriptions, including full-employment strategies, education reform, technological development, capital formation, and multicrop diversification, to help

strengthen the developing countries of Asia and free them from the seasonal prison of the monsoon.

Peter C. Y. Chow and Mitchell H. Kellman

Trade: The Engine of Growth in East Asia

Oxford University Press, New York, NY, USA, 1993, x + 172 pp., \$35.

Can trade really break the vicious cycle of poverty for a poor small country and be an engine of growth? According to Chow and Kellman, it can. Their book focuses on East Asia and, specifically, four economies in the region: Hong Kong, the Republic of Korea, Singapore, and Taiwan Province of China. Against what would seem overwhelming odds, these four vastly different economies, including two city states, have succeeded in using trade to do just that.

Chow and Kellman provide a well-thought-out exposition of how these four "tigers" achieved their economic success, despite such obstacles as protectionism. Their arguments that in the early period the four were dependent on imports, that they emulated Japan's export pattern, that they followed the five-stage development process suggested by Bela Balassa and others, and that they had a homogeneous export response to the United States are supported by ample empirical data. What is

more, the authors believe that other countries in Asia are also following in their footsteps. They even venture projections for the state of the four tigers and upcoming "cubs" up to the year 2000. A comparison with countries in other regions, such as Latin America and Africa, to see if such success could be replicated elsewhere would have been a satisfying addition to the book.

Jesko Hentschel

Imports and Growth in Highly Indebted Countries

An Empirical Study

Springer-Verlag, New York, NY, USA, 1992, vii + 209 pp., \$69.

Faced with a sharp decline in real imports of capital and intermediate goods in the 1980s, many highly indebted countries had to replace previously imported factors of production with domestic capital and labor. This book, an empirical study of 12 developing countries, examines the extent to which these economies were dependent on imports of capital and intermediate goods in the 1970s and 1980s. The results indicate that countries that followed inward-oriented strategies did not necessarily reduce their dependence on imports. Rather, for some countries, import vulnerability increased.

Credits: Cover art and art on pages 2, 7, 16, and 20: Mark Robinson. Art on pages 24 and 25: Phil Torsani. Art on pages 10, 13, 14, 38, 39, 40, and 41: Luisa Watson. Charts on pages 28 and 29: Dale Glasgow. IMF photos: Padraic Hughes-Reid. Bank photos: M. Iannacci. Photo on page 32: FAO. Photo on page 42: United Nations.

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AIR

Public Information Center Opened January 3

Previously Confidential Documents Now Available to the Public

The World Bank is increasing the amount of information it makes available to the public through a new information center, which opened in Washington on January 3. A similar facility opened the same day at the Bank's offices in Paris and Tokyo, and shortly thereafter in London.

The Bank's new Public Information Center will enable the public to receive a wide range of documents about Bank-supported projects and work in member countries. The center is part of the Bank's more open information policy approved by its executive directors on August 26, 1993.

Academics, investors, non-governmental organizations and any other individual or group will be able to use the center, located in the Bank's "G" building at 1776 G Street, N.W., Washington, D.C. The phone number is (202) 458-5454; fax: (202) 522-1500. The center offers documents related to all projects approved by the Bank's board as of January 3. The cost for each document is \$15.

For any documents relating to projects approved before January 3, the World Bank country department in charge of the project must be contacted directly.

Documents Available through the Public Information Center

People requesting information must ask for specific documents. The information center is unable to handle general requests for information. The public may obtain the following types of documents:

- Project Information Documents (PIDs). These include the main elements of a project before it is submitted to the World Bank's Board of Executive Directors for approval. Components of the PIDs are expected to include costs and financing, environmental and other issues, and names of government agencies that can provide information about the project.
- Environmental Assessments (review the potential environmental impact of individual projects)
- Environmental Assessments and Executive Summaries for IFC-Funded Projects (for "Category-A" projects expected to have major environmental impact)
- Environmental Data Sheets (updated quarterly for each project in the Bank's lending program)
- National Environmental Action Plans (obtainable when governments consent to their publication)
- Staff Appraisal Reports (SARs) (available after projects are approved by the Board)
- Summaries of Evaluation Reports (prepared by the Bank's independent Operations Evaluation Department)
- Country Economic and Sector Reports (include information about a country's economy, particular sectors, poverty assessments, private sector assessments, and public expenditure reviews)
- Sectoral Policy Papers

Information through the Internet

A variety of documents is available free through the Internet. Internet users can access a new World Bank information service that provides: Project Information Documents; Environmental Data Sheets; the World Bank's publications catalog; an overview of the World Bank's public information system.

Later in 1994, the World Bank's electronic information system will provide a larger number of documents.

Internet users accessing the Bank's information system through NCSA Mosaic or other World Wide Web navigation tools should use the following universal resource locator:

<http://www.worldbank.org>

For individuals using a Gopher tool, the server address is:

<gopher.worldbank.org>

If you encounter problems gaining access to the World Bank's system through the Internet, send electronic mail to: pic@worldbank.org.

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